CHAPTER

3

Options That Affect Revenues

Revenue Option 1

Combine the Personal Exemption and the Standard Deduction

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues							
Taxpayer only	11.4	27.2	24.0	21.4	20.3	104.3	233.7
Taxpayer and spouse	15.7	37.5	33.1	29.7	28.3	144.3	328.7

Source: Joint Committee on Taxation.

To compute their taxable income under current law, taxpayers subtract personal exemptions and either the standard deduction or itemized deductions from their adjusted gross income (AGI). The law allows personal exemptions for the taxpayer, his or her spouse, and any dependents. In 2002, each personal exemption that a taxpayer claimed reduced AGI by $3,000. High-income taxpayers are treated differently, however; for them, the value of personal exemptions phases out above certain income thresholds.

Taxpayers may further reduce their AGI by claiming either the standard deduction or certain itemized deductions. In 2002, the standard deduction was $4,700 for single taxpayers and $7,850 for married taxpayers filing jointly. Itemized deductions are specific expenses that taxpayers are allowed to subtract from their income; they include contributions to charities, home mortgage interest, state and local income and property taxes, and certain medical expenses. Again, above certain income thresholds, the law reduces the value of itemized deductions for high-income taxpayers. In 1999, roughly two-thirds of tax returns (86 million) claimed the standard deduction, and the remaining 40 million claimed itemized deductions.

This option would combine the personal exemption for the primary taxpayer with the standard deduction to yield a higher standard deduction. A corollary option would add the personal exemption for the taxpayer's spouse to that combination to provide a higher standard deduction for married couples filing a joint return. Combining the primary personal exemption with the standard deduction would increase revenues by $104.3 billion over the 2004-2008 period; if the spousal exemption was included, revenues would increase by $144.3 billion over the five-year span.

Under this option, the tax liability of some people would rise, but most taxpayers' liability would be unaffected. Taxpayers who currently claim the standard deduction would see no change in their taxes. However, taxpayers who currently itemize but have itemized deductions that are less than the value of the combined personal exemption and standard deduction would choose to claim the combined standard deduction; as a result, their taxable income would rise by the amount that their itemized deductions exceeded the current standard deduction. Taxpayers who itemize and have itemized deductions above the combined value of the personal exemption and standard deduction would still choose to itemize, but they would see their taxable income increase by the amount of the personal exemption. High-income taxpayers who could not claim personal exemptions because of their income level would see no change in their tax liability.

By eliminating the primary personal exemption, the option would shift 9 million taxpayers from claiming itemized deductions to claiming the standard deduction; eliminating the personal exemption for a spouse would move an additional 5 million. Those taxpayers would no longer have to keep detailed records to justify their itemized deductions, which would lessen the complexity of the tax system. Proponents of this alternative might also argue that it would increase economic efficiency, since taxpayers who no longer itemized would not receive tax-favored treatment that lowered the after-tax price of selected goods, such as mortgage-financed, owner-occupied housing.

Opponents of this option would argue that the activities reflected in itemized deductions serve important purposes and should continue to be favorably treated under tax law. Some of those deductions are designed to encourage activities with social benefits, such as charitable giving, and a reduction in tax incentives for those activities, say opponents, would lead to less of them. Other itemized deductions, such as those for health expenses, casualty losses, and employee business expenses, are allowed because they lower a taxpayer's disposable income; deducting them more accurately measures a person's ability to pay income tax. Eliminating the tax reductions associated with those expenses for taxpayers who no longer itemize would create a less equitable tax system.

Revenue Option 2

Eliminate the Deductibility of Interest on Home-Equity Debt

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.4	0.5	0.5	0.5	0.5	2.4	5.7

Source: Joint Committee on Taxation.

The amount of mortgage interest that can be deducted from adjusted gross income is limited to the interest on up to $1 million of acquisition indebtedness and $100,000 of home-equity debt. (The limits do not apply to mortgages taken out before October 14, 1987.) As defined in the tax code, acquisition indebtedness is a mortgage that is used to buy, build, or substantially improve a primary residence or a second home. Home-equity debt is all other debt that is mortgaged against such homes. Eliminating the deductibility of interest on home-equity debt would raise $0.4 billion in revenues in 2004 and a total of $2.4 billion from 2004 through 2008.

Home-equity debt can arise either from taking out a home-equity loan or from refinancing an existing mortgage with a larger one. If a homeowner takes out a home-equity loan for more than he or she spends on home improvements at that time, the Internal Revenue Service (IRS) considers the excess loan to be home-equity debt. Similarly, if a homeowner refinances at a higher loan amount than the outstanding balance on his or her original loan, and spends less than the increase on home improvements, the IRS considers the excess to be home-equity debt.

Home-equity loans and refinancing have become common, but the IRS would not classify all of that borrowing as home-equity debt. In the late 1990s, 13 percent of homeowners had home-equity loans and 16 percent of homeowners with mortgages had cashed out some of their equity when they refinanced. Most loans and cash-outs were well below the $100,000 limit; only about one-fourth of either type was for $25,000 or more. Both types of borrowing are commonly used to pay for home improvements—and to that extent qualify as acquisition indebtedness—but they are also used to pay off other debts, to invest in businesses or real estate, and to finance household spending for automobiles, medical expenses, education, and vacations.

In general, taxpayers may not deduct from adjusted gross income so-called personal interest—that is, interest on credit card debt, car loans, and personal loans. An exception is made for home mortgages because of the public benefits that are believed to result from home ownership—for example, greater involvement in the community and better home maintenance. Allowing a deduction for interest on home-equity debt results in certain homeowners being able to circumvent the ban on deducting personal interest. Homeowners who itemize and who have sufficient equity in their homes can take out a home-equity loan to pay off credit card debt, buy a car, or cover other personal expenses. Renters and homeowners who do not have sufficient equity or do not itemize cannot circumvent the personal interest ban. That differential treatment is not only inequitable but also encourages greater indebtedness on the part of taxpayers who are allowed to skirt the restriction on deducting personal interest. Ending the deductibility of interest on home-equity debt would still leave substantial tax incentives to encourage home ownership. Such inducements include the continued deductibility of debt to buy, build, or improve a home; the absence of taxation on the value of the housing services that owners provide to themselves; and the exclusion from taxation of most capital gains realized on home sales.

The option has several drawbacks, however, that argue against its adoption. One is that it would subject many more homeowners to complex recordkeeping and tax-filing requirements. Today, only the relatively few owners who borrow more than $100,000 of home-equity debt must keep track of the proportion whose interest is deductible. But under this option, most owners who took out home-equity loans or cashed out some of their equity when they refinanced would have to make those calculations.

A related drawback would be the cost of enforcing the option. Currently, the IRS enforces the $100,000 limit on home-equity debt primarily through audits, very few of which are conducted for that purpose. Few taxpayers violate the limit, so noncompliance is not a major problem. But under this option, enforcement would become more important because many more homeowners would be subject to a ban on deducting interest from home-equity debt. Furthermore, enforcement on a larger scale would require lenders to report more information than they do now and homeowners to provide documentation of their home-improvement expenses. (However, any substantial increase in enforcement by the IRS would bring in additional revenues beyond the estimates above, which were based on current levels of enforcement.)

Also of potential concern is that this option would treat owners who moved more favorably than owners who stayed put. Movers can borrow against their homes for other purposes by taking out a larger mortgage than they need to pay off the old mortgage and finance any increase in the price of the new home. The IRS considers all of that debt to be acquisition debt as long as the new mortgage is smaller than the price of the new home. Thus, an owner who did not move would gradually pay down his or her mortgage and not be able to deduct interest on borrowing to buy, say, a new car. But an owner who moved to a similarly priced house would be able to take out a mortgage equal to the debt on the old house plus the cost of the car. The mover could then use the extra money from the loan to pay for the car and deduct all of the interest payments.

Favoring owners who move not only seems inequitable but also encourages owners to relocate and therefore probably lessens their interest in becoming involved in their communities. In that way, the option undermines one of the primary purposes of allowing the mortgage interest deduction. The option also encourages homeowners to take out larger mortgages when they move than they otherwise would, which increases their chances of losing their home in the future.

Revenue Option 3

Eliminate Deferred Taxation of Like-Kind Exchanges

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.2	1.2	1.2	1.3	1.3	5.2	12.6

Source: Joint Committee on Taxation.

The tax code requires people who sell or exchange capital assets to report any capital gain or loss as part of their taxable income. An exception is exchanges of certain similar assets, mainly real estate. The law recognizes no gain or loss if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for the same reasons. In those exchanges, people carry over to the new property any gain that has accrued on the old asset, and they do not pay tax on that gain until the new property is sold. Like-kind real estate assets are broadly defined as any properties located in the United States.

In some exchanges, two owners swap like-kind property, but in many instances, a single owner sells one property to a second party and purchases a replacement property from a third. For those transactions to qualify as like-kind exchanges, the proceeds from the sale of the original property must be held outside the seller's control—for example, by a qualified intermediary—and used to purchase the replacement property. In addition, the like-kind replacement property must be identified within 45 days of the sale and purchased within 180 days.

By deferring taxation, the tax code treats capital gains from like-kind exchanges more favorably than gains that are made in trading many other assets. Any gain realized from selling one stock to purchase another, for example, or from selling a share in one partnership to purchase a share in another is taxable in the year of the exchange. Gains from trades of bonds, mortgages, and other debt instruments are similarly taxed. This option would eliminate the deferral for like-kind exchanges, making the tax system more equitable. That change would raise $0.2 billion in revenues in 2004 and a total of $5.2 billion from 2004 to 2008.

An argument that is sometimes used to justify the current treatment of like-kind exchanges is that the new property is a continuation of the same investment as the previous one and no tax should be levied until the owner leaves that line of investing. Also, it is argued, when owners simply swap property, without cash changing hands, no money becomes available for paying the tax. Furthermore, allowing like-kind exchanges helps property owners respond more easily to changing conditions in their lives or in property markets. But, as proponents of this option contend, those justifications apply as well to many exchanges of stocks, bonds, and partnership shares and therefore do not support treating real estate and certain other exchanges differently from exchanges of assets such as stocks and bonds.

One reason for either continuing the current treatment of like-kind exchanges or phasing it out slowly is that many investors purchased property with the understanding that they would be able to exchange it for other property without paying capital gains taxes. Changing the tax treatment abruptly would impose hardships on some investors and could depress property prices. Another reason for continuing the current treatment is that like-kind exchanges are not the only such transactions on which gains taxes are deferred: the tax code permits deferral on swaps of corporate equities in business mergers as well as on exchanges involving property that is condemned, destroyed, or stolen—known as involuntary conversions. As that term suggests, however, such transactions differ from like-kind exchanges by being largely beyond the property owner's control.

In the past, the Congress has considered limiting the amount of the gain that owners can defer under like-kind exchanges of real property. Proposals have also been made to defer gains only on exchanges of properties that are related or similar in service or use. Although that stricter standard already applies to gains on certain involuntary conversions, applying it on a broader scale would present problems in administration because of the extensive effort required to determine whether assets are similar in service or use.

RELATED OPTIONS: Revenue Options 4 and 43

Revenue Option 4

Limit Deductions for Charitable Gifts of Appreciated Property to the Gifts' Tax Basis

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.4	1.9	2.0	2.0	2.1	8.4	19.6

Source: Joint Committee on Taxation.

Under current law, taxpayers who itemize deductions may deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of their adjusted gross income in any year. Through that deduction, the federal government provides a significant incentive to support philanthropic activities. In addition to donating cash, taxpayers may contribute assets such as stocks or works of art. Taxpayers who contribute property that has appreciated in value receive special treatment under the tax code. As a general rule, if the taxpayer has held the property for more than 12 months, he or she may deduct its fair market value at the time of the gift—regardless of its original price.

This option would limit the deduction for appreciated property to its tax basis—the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. That change would increase revenues by about $0.4 billion in 2004 and more than $8.4 billion over five years.

The existing provision allows taxpayers to deduct the entire value of assets that they contribute to charities even though they have paid no tax on gains from the assets' appreciation. That arrangement treats the donation of appreciated assets more advantageously than other types of donations—for example, cash—and expands the preferential treatment of capital gains in the tax code (see Revenue Option 3). The current provision also encourages people to donate appreciated assets to eligible charities during their lifetime rather than leave them to their heirs at death.

RELATED OPTION: Revenue Option 3

RELATED CBO PUBLICATION: *Effects of Allowing Nonitemizers to Deduct Charitable Contributions*, December 2002

Revenue Option 5

Eliminate the Earned Income Tax Credit for People Who Have No Children

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	*	0.7	0.7	0.8	0.8	3.0	6.9

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

Policymakers added the earned income tax credit (EITC) to the tax code in 1975 to supplement the wages of low-income families. Originally, the law applied only to families with one or more children. However, in 1994, the program was expanded to include a small credit for low-income individuals with no children. This option would eliminate the childless EITC, lessening the tax code's complexity and raising $3 billion in revenues over the 2004-2008 period.

For 2004, the tax credit is scheduled to phase in at a rate of 7.65 percent—the payroll tax rate for employees—over the first $5,110 of income, yielding a maximum credit of $391. (As an example, a qualifying individual with earnings of $2,000 would receive a credit of $153.) It then phases out at the same rate for earnings above specified thresholds—$7,150 for married couples filing jointly and $6,150 for all others. The phaseout range for the childless EITC begins at less than half the income threshold for families with children, which limits the number of people who are eligible for the credit. In 1999, 3.2 million taxpayers received credits averaging $200. Fewer than 400,000 people received the full credit. About 1.2 million recipients had income within the phase-in range, and roughly 1.6 million were in the phaseout range.

Proponents of this option might point out that in addition to raising revenues, it would eliminate a program that provided little benefit but posed a substantial administrative burden. The paperwork for the EITC is complicated, and almost every person eligible for the childless credit would not have to file a tax return if he or she were not claiming the credit.

Opponents of the option might contend that the credit, though small, provides some assistance to low-income workers. Eliminating the program would reduce government assistance to society's most financially needy individuals.

Revenue Option 6

Include Social Security Benefits in Calculating the Phaseout of the Earned Income Tax Credit

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues[a]	*	0.2	0.2	0.2	0.2	0.8	1.6

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

a. Includes outlay savings.

Under current law, the earned income tax credit (EITC) phases out as the larger of earned income or adjusted gross income (AGI) exceeds a certain threshold. However, AGI excludes most income from government transfer programs such as Social Security, and as a result, low-income families that receive sizable transfers can claim the EITC with the same total income that will reduce or deny the credit to otherwise comparable families whose income is fully included in their AGI. The tax code already requires some Social Security benefits to be counted: for single taxpayers with income above $25,000 and joint filers with income above $32,000, AGI includes up to 85 percent of any Social Security benefits. This option would require taxpayers to include all Social Security benefits in a modified AGI that would be used for phasing out the EITC. That change would increase federal revenues and decrease outlays for the credit by $800 million over the 2004-2008 period.

One argument in support of this option is that it would make the EITC fairer. Counting all Social Security benefits in the calculation for phasing out the credit would give the same EITC to both low-income taxpayers who receive Social Security and claim the credit and otherwise comparable taxpayers whose income derives entirely from sources that are fully included in their AGI. In addition, because the Internal Revenue Service (IRS) already receives information on taxpayers' Social Security benefits, the administration of this option would require only minor procedural changes.

But the modified AGI would still exclude some transfer income; hence, this option would not resolve the problem that families with the same total income receive different credits. The IRS does not currently collect information on most forms of taxpayers' transfer income other than Social Security. As a result, requiring taxpayers to count all such income would substantially expand the information reported to the IRS and markedly increase taxpayers' "costs" of compliance (for example, time spent filling out forms). Furthermore, because most transfer income that is not included in AGI is from means-tested programs (which tie benefit eligibility to a test of need based on income and assets), counting all transfers in phasing out the EITC would offset, at least in part, the goal of providing support to low-income recipients. Even so, excluding transfers from the income measure used to phase out the credit would treat otherwise similar taxpayers differently.

Another consideration is that counting Social Security benefits for the EITC phaseout would increase the costs of compliance for Social Security recipients who claim the credit and would further complicate the already complex form such taxpayers must complete. Those outcomes would run counter to recent efforts to simplify procedures for claiming the earned income tax credit.

Revenue Option 7

Substitute a Tax Credit for the Exclusion of Interest Income on State and Local Debt

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.3	0.6	0.9	1.3	1.6	4.7	14.5

Source: Joint Committee on Taxation.

The tax code allows owners of state and local bonds to exclude the interest they earn on those bonds from their gross income and thus from income tax. As a result, state and local governments pay lower interest rates on such bonds than would be paid on bonds of comparable risk whose interest was taxable. The revenues that the federal government forgoes exceed $26 billion per year and effectively pay a portion of the costs that state and local governments incur when they borrow.

This option would replace the exclusion of interest income on new issues of state and local debt with a tax credit that, unlike most credits, would be included in adjusted gross income. Under the option, the bondholder would receive a taxable interest payment from the state or local government that issued the bond plus a federal tax credit that would provide the bondholder with an after-tax return comparable with that provided by a tax-exempt bond. The option would retain existing restrictions that now apply to the issuance of tax-exempt bonds. It would raise $0.3 billion in 2004 and $4.7 billion over the 2004- 2008 period.

Switching to a tax credit rather than excluding interest paid on state and local debt from the gross income of bond purchasers would have several effects. It could reduce state and local governments' borrowing costs by a percentage similar to the reduction that the exclusion provides but with a smaller loss of federal revenues. The loss would be smaller because switching to a credit would eliminate gains for bondholders in higher marginal tax brackets that exceed the investment return necessary to induce them to buy the bonds. In addition, the size of the tax credit could be varied to allow the Congress to adjust the size of the federal subsidy—on the basis of the perceived benefit to the public—for different categories of state and local borrowing. Nevertheless, substituting a tax credit for the exclusion would keep the federal subsidy akin to an entitlement.

Another effect of switching to a tax credit is that it might raise the interest rate on state and local government borrowing. For example, it would lower the bonds' after-tax returns for people with higher marginal tax rates and thus lead them to buy fewer bonds. If that drop in demand for bonds was not offset by increased demand from other investors, state and local borrowing costs would be reduced by a smaller percentage than they currently are, and interest rates on state and local debt would rise. Paying higher rates for borrowing could lead state and local governments in turn to reduce investments in capital facilities.

Revenue Option 8

Restrict the Tax Exclusion for Qualified Parking to Locations from Which Employees Commute in Vans and Carpools

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.7	0.8	0.8	0.8	0.8	3.9	7.9

Source: Joint Committee on Taxation.

The tax code allows employees to exclude from their taxable income the value of certain expenses for transportation that are paid by their employers. Those expenses include transportation in a van or other commuter highway vehicle, transit passes, and so-called qualified parking. (Qualified parking can be parking at or near an employer's place of business as well as parking provided at or near a place from which the employee commutes to work in a commuter highway vehicle or carpool.) The law limits the monthly amount that can be excluded from an employee's income to $100 for commuter highway vehicles and transit passes and $185 for qualified parking. In effect, the tax exclusion provides an incentive from the federal government (in the form of lower taxes) to use those means of transportation.

Under this option, employees would be able to exclude only their costs for parking at sites from which they continue on to work in a commuter highway vehicle or carpool and not their costs for parking at or near their job. The option would increase revenues by $0.7 billion in 2004 and $3.9 billion over the 2004-2008 period.

By raising the cost of commuting by private vehicle, this option could lead workers to drive less and thereby reduce air pollution and traffic congestion. Those outcomes might be more efficient than the current situation in which drivers do not bear the full cost of the pollution and congestion that they cause and so may drive more than is efficient. The incentive that the tax exclusion provides for parking at work exacerbates that problem by further encouraging workers to drive. Moreover, because the incentive for parking exceeds the incentive for mass transit, workers who would otherwise be indifferent to which of the two modes of transportation they used will choose to commute by car.

Some drivers would continue to drive to work even without the exclusion. For people who lack good alternatives to driving, eliminating it would be costly. Furthermore, the current incentive for mass transit may already offer an economically appropriate inducement for commuters to use public transportation rather than to drive. Finally, taxing the value of parking would increase the reporting required of employers and complicate the completion of tax returns for many workers.

RELATED OPTIONS: Revenue Options 36, 37, 38, and 39

Revenue Option 9

Include Employer-Paid Life Insurance in Taxable Income

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues							
Individual income tax	1.2	1.7	1.7	1.7	1.8	8.1	18.0
Payroll tax	0.6	0.9	1.0	1.0	1.1	4.6	10.3

Source: Joint Committee on Taxation.

Tax law excludes from taxable income the premiums that employers pay for employees' group term life insurance, but it limits that exclusion to the cost of premiums for the first $50,000 of insurance. (The exclusion is not available to self-employed people.) Of the fringe benefits that offer a tax advantage to their recipients, employer-paid life insurance is the third most expensive in terms of lost revenues (after health insurance and pensions). If premiums for employer-paid life insurance were included in employees' taxable income, individual income tax revenues would rise by $8.1 billion from 2004 through 2008, and payroll tax revenues would increase by $4.6 billion.

Excluding life insurance premiums from taxation has ramifications for both efficiency and equity. Like the tax exclusions for other employment-based fringe benefits, the exclusion for life insurance creates an incentive that induces people to purchase more life insurance than they would if they had to pay the full cost of it themselves. Furthermore, excluding premiums from taxation allows workers whose employers purchase life insurance for them to pay less tax than workers who have the same total compensation but must purchase insurance on their own.

Those factors, which some people might view as arguments in support of this option, are reinforced by the relative ease with which it could be implemented. The value of employer-paid life insurance, unlike the value of some other fringe benefits, can be accurately measured and allocated. Employers could report the premiums they paid for each employee on the employee's W-2 form and compute withholding in the same way as for wages. Indeed, employers already withhold taxes on the life insurance premiums they pay that fund death benefits above the $50,000 limit.

Yet a tax incentive to purchase life insurance might be called for in certain circumstances. One such case might be if people bought too little life insurance because they systematically underestimated the potential financial hardship for their families that their death might bring. Whether, in fact, people purchase too little insurance for that reason is unclear. Moreover, even if too little life insurance was purchased, a more efficient way of encouraging people to buy it might be to extend the favorable tax treatment to all purchasers and avoid favoring only people with insurance provided by employers.

RELATED OPTION: Revenue Option 10

Revenue Option 10

Include Investment Income from Life Insurance and Annuities in Taxable Income

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	11.2	22.6	23.2	23.8	24.4	105.2	236.7

Source: Joint Committee on Taxation.

Life insurance policies and annuities often combine features of both insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which a person pays a single premium, or a series of premiums, and the company provides a series of fixed or variable payments to that person at some future time, usually during retirement.) The investment income from the money paid into life insurance policies and annuities, sometimes called inside buildup, is not taxed until it is paid out to the policyholder. If it is left to the policyholder's estate or used to pay for life insurance (in the case, for example, of whole-life policies), it can escape taxation entirely. The tax treatment of inside buildup is similar to the taxation of capital gains.

Under this option, life insurance companies would inform policyholders annually—just as mutual funds do now—of the investment income realized on their account, and people would include those amounts in their taxable income. As a result, disbursements from life insurance policies and benefits from annuities would no longer be taxable when they were paid. Making such investment income taxable as it was realized would raise $11.2 billion in 2004 and a total of $105.2 billion from 2004 through 2008; in addition, its tax treatment would then match that of income from a bank account, taxable bond, or mutual fund. Tax on the investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be deferred until benefits were paid.

By taxing the investment income from life insurance policies, this option would eliminate a tax incentive to purchase life insurance, which may or may not be useful. Encouraging such purchases would be desirable if people systematically underestimated the financial hardship that their death would impose on spouses and families. Such shortsightedness could cause them to buy too little life insurance or, similarly, too little annuity insurance to protect themselves against outliving their assets. However, there is little evidence of such shortsightedness.

A drawback of using tax-deferred savings as an incentive to purchase life insurance is that it provides no inducement to purchase term life insurance (because term insurance has no savings component). Under the assumption that some incentive to purchase insurance would, indeed, be useful, an alternative approach might be to encourage the purchase of life insurance directly, by giving people a tax credit for their insurance premiums or by allowing them to take a partial deduction. Annuities already receive favorable tax treatment through special provisions for pensions and retirement savings.

RELATED OPTION: Revenue Option 9

Revenue Option 11

Raise the Age Limit from 14 to 18 for Taxing Investment Income Under the Kiddie Tax

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	*	0.1	0.1	0.1	0.1	0.4	0.7

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

Investment income that is received by a dependent child under age 14 and that exceeds specified limits is taxed at the parents' marginal rate (the rate of tax on the last dollar earned). In 2001, the applicable limit on such income was $1,500. The provision—often referred to as the kiddie tax—is intended to restrict parents' ability to reduce the income tax on their investment income by transferring ownership of income-producing assets to their young children. It does not, however, preclude parents from cutting their tax bill by giving such assets to children older than 13. Under current law, income from assets in the name of a child over age 13 is taxed at the child's rate, which is generally 10 percent or 15 percent, rather than at the parents' rate, which can be as high as 37.6 percent in 2004. As an example, the difference in rates on $10,000 in annual income from assets can cut the family's tax bill from $3,760 to $1,000, or by more than 70 percent.

This option would raise the age limit—from 14 to 18—below which a child's income from investments is taxed at the parents' rates. The option would increase income tax revenues by $400 million over the 2004-2008 period.

Extending the kiddie tax to the income of older children would help prevent parents from sheltering assets to reduce the taxes they have to pay. But the assets of older children may be their own. A teenager may have earned and saved a substantial amount of money or may have received sizable gifts. In that case, it is reasonable to tax the income from those assets at the child's rate rather than the parents'. Indeed, imposing the parents' higher rate could discourage teenagers from saving their earnings or gifts.

Revenue Option 12

Include in Adjusted Gross Income All Income Earned Abroad by U.S. Citizens

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.7	3.0	3.2	3.4	3.6	13.9	34.4

Source: Joint Committee on Taxation.

U.S. citizens who live abroad are required to file a tax return but may exclude from taxation some of the income they earn there—in 2002, up to $80,000 for single filers and as much as $160,000 for qualifying married couples. That exclusion, along with one for foreign housing and the usual personal exemptions and deductions, means that Americans residing abroad and earning close to $100,000 may not incur any U.S. tax liability, even if they pay no taxes to the country in which they reside. U.S. citizens with foreign-earned income above the exclusion amount also receive credits for taxes they pay to foreign governments, which may eliminate tax liability on that income under the U.S. tax system.

This option would retain the credit for taxes paid to foreign governments but include in adjusted gross income all income earned abroad by U.S. citizens residing there. Thus, under the option, Americans living in foreign countries that have tax rates higher than those in the United States would generally not owe U.S. tax on their earned income, whereas those living in relatively low-tax countries could have some U.S. tax liability. The option would increase revenues by $0.7 billion in 2004 and $13.9 billion over the 2004-2008 period.

Proponents and opponents of this option part company on issues of equity and efficiency. Proponents argue that U.S. citizens should pay U.S. taxes under this country's tax system because they still receive the benefits of citizenship, even as foreign residents. They also maintain that U.S. citizens with similar income should incur similar tax liabilities, regardless of where they live, and note the unfair advantage gained by individuals who have moved to low-tax foreign countries to escape U.S. taxation while retaining their American citizenship. In contrast, opponents note that U.S. citizens who live in other countries do not receive the same volume of government services that U.S. residents receive. They also argue that the exclusion of foreign-earned income makes it easier for U.S. multinational firms to find American employees who are willing to work and live abroad.

Revenue Option 13

Expand the Medicare Payroll Tax to Include All State and Local Government Employees

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.9	1.1	1.1	1.0	0.9	5.0	8.0

Source: Congressional Budget Office.

Certain groups of employees of state and local governments are not covered by Medicare on the basis of that employment and thus do not pay the Medicare payroll tax. (All federal employees have been covered since 1983, as required by the Tax Equity and Fiscal Responsibility Act of 1982.) The Consolidated Omnibus Budget Reconciliation Act of 1985 mandated that state and local employees who began work after March 31, 1986, pay Medicare payroll taxes, but it did not make coverage mandatory for people hired before that date. The Omnibus Budget Reconciliation Act of 1990 expanded Medicare tax coverage to include all state and local government employees who were not covered by a state or local retirement plan.

Making all state and local government employees who are not now covered under Medicare subject to the payroll tax would raise $0.9 billion in revenues in 2004 and a total of $5.0 billion from 2004 through 2008. The annual gain in receipts would decline gradually as employees who were hired before April 1986 left the payrolls of state and local governments.

Only one out of 10 state and local employees is not covered by Medicare through their employment, but most of those workers will still receive Medicare benefits when they retire because under current law, many of them will qualify for benefits on the basis of other employment in covered jobs or through their spouse's employment. As a result, requiring all state and local employees to pay Medicare payroll taxes could be justified on grounds of fairness. The program's broader coverage would lessen the inequity of the high levels of benefits received by those employees in relation to the payroll taxes they paid. Of course, expanding Medicare coverage to include more state and local employees would increase the federal government's liability for future benefits under the program.

Revenue Option 14

Calculate Taxable Wages in the Same Way for Both Self-Employed People and Employees

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues							
On-budget	0.2	0.3	0.3	0.3	0.3	1.4	3.1
Off-budget	0.2	0.2	0.2	0.2	0.2	1.0	2.2

Source: Congressional Budget Office.

Social Security and Medicare levies come in two forms: the Federal Insurance Contribution Act (FICA) tax paid on wages and the Self-Employment Contribution Act (SECA) tax paid on income from self-employment. Under FICA, employees and employers each pay a Social Security tax of 6.2 percent on wages up to a taxable maximum ($87,000 in 2003) and a Medicare tax of 1.45 percent on all wages. Until 1983, the SECA rate was lower than the combined employer and employee rate under FICA. As part of the Social Security Amendments of 1983, the Congress increased the effective SECA rates starting in 1984. The conference committee said that the law was "designed to achieve parity between employees and the self-employed" beginning in 1990.

Despite the Congress's stated intent, the current method for calculating SECA taxes allows a self-employed taxpayer to pay less tax than a worker with the same nominal income who is not self-employed. For example, an employee who earns $50,000 and his or her employer each pay $3,825 in FICA taxes, so that employee's total compensation is $53,825 (the employer's share is considered compensation), and the total FICA tax is $7,650. But if that worker's self-employed sibling also earned total compensation of $53,825, he or she would pay only $7,605 in SECA taxes, or $45 less than the employee sibling would pay. The difference arises because the self-employed sibling will have a calculated taxable income base that is lower than that of the employee sibling. Under current law, the income base on which self-employed people calculate their tax equals total compensation less 7.65 percent. Thus, the self-employed sibling pays taxes on $49,707, but the employee sibling pays taxes on $50,000.

Among people with earnings above Social Security's taxable maximum, workers who are self-employed pay the same amount of Social Security tax that employees pay, but they pay less Medicare tax. For example, an employee earning $100,000 and his or her employer each pay $5,394 in Social Security taxes and $1,450 in Medicare taxes, so that employee's total compensation is $106,844 and the total FICA tax is $13,688. That person's self-employed sibling—with the same total compensation—pays the same maximum Social Security tax but only $2,861 in Medicare taxes, or $39 less. (The self-employed person pays Medicare taxes on $96,824, whereas the employee pays Medicare taxes on $100,000.) High-income, self-employed taxpayers may pay as much as 6.3 percent less in Medicare taxes under SECA than employees with similar total compensation pay under FICA. That difference has existed since 1991, when the Congress first set the taxable maximum for Medicare higher than the taxable maximum for Social Security. Eliminating the difference would require a slight change in Schedule SE (the income tax form for reporting self-employment income), but it would directly affect only a relatively small percentage of self-employed taxpayers—those with income above the taxable maximum.

Changing the formula for calculating SECA taxes would increase on-budget revenues by $1.4 billion from 2004 to 2008. Off-budget SECA revenues, which are credited in the Social Security trust funds, would increase by $1.0 billion.

Revenue Option 15

Subject All Earnings to the Social Security Payroll Tax

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	66.0	91.8	97.2	103.4	109.9	468.4	1,128.4

Source: Congressional Budget Office.

Social Security—which is composed of the Old-Age, Survivors, and Disability Insurance (OASDI) programs—is financed by a payroll tax on employees, employers, and self-employed people. The receipts from that tax go to trust funds (essentially accounting mechanisms that the government uses to track receipts and spending for programs with specific taxes or other revenues earmarked for their use). Only earnings up to a specified maximum amount are taxed, although that amount automatically increases each year. (In 2003, the maximum amount of earnings taxed under Social Security is $87,000.) This option would make all earnings subject to the payroll tax, generating $66 billion in receipts in 2004 and a total of about $468 billion from 2004 through 2008. Some of those revenues, however, would be offset by the additional retirement benefits that Social Security would pay to people with income above the current law's maximum taxable amount.

When Social Security began in 1937, about 92 percent of the earnings from jobs covered by the program were below the maximum taxable amount. That percentage gradually declined over time because the maximum rose only occasionally, when the Congress enacted specific increases to it. In the 1977 amendments to the Social Security Act, the Congress raised the percentage of covered earnings subject to the tax to 90 percent by 1982 and also provided for an automatic increase in the ceiling each year thereafter equal to the growth in average wages. Despite that indexing, the fraction of taxable earnings has slipped over the past decade as a result of faster-than-average growth in the earnings of the highest-paid workers. In 2000, approximately 85 percent of earnings from employment covered by OASDI fell below the maximum.

Subjecting all earnings to the payroll tax, proponents of this option argue, would have several positive effects—for example, it would improve the balances of the OASDI trust funds. Proponents also contend that the option would increase the progressivity of the payroll tax. Because people who have income above the ceiling do not pay the tax on all of their earnings, they pay a lower share of their total income in payroll taxes than do people whose total earnings fall below the maximum. Making all earnings taxable would raise payroll taxes for high-income earners, making the tax more progressive. Although that change could also entitle people with earnings above the old maximum to higher Social Security payments when they retired, the additional benefits would be small relative to the additional taxes those earners would have to pay. An alternative option would maintain a cap on earnings subject to tax but raise it substantially above its current level of $87,000. Doing so would generate less additional revenue and increase the progressivity of the tax system by less than would a complete removal of the cap.

Opponents of this option could argue that improving the solvency of the trust funds on paper would not necessarily improve the economy's ability to pay future benefits, since the trust funds are only accounting mechanisms. Removing the earnings cap could also weaken the link between the taxes that workers pay into the system and the benefits that they receive, an important aspect of the Social Security system since its inception. Additionally, this option would reduce the rewards from working for people whose earnings are above the maximum now, because those earnings would become subject to the payroll tax. As a result, such workers would have an incentive to work less or to take more compensation in the form of fringe benefits that would not be subject to payroll taxes.

RELATED CBO PUBLICATION: *Social Security: A Primer*, September 2001—see pp. 42-43 for a more detailed discussion of trust funds.

Revenue Option 16

Eliminate the Source Rules Exception for Inventory Sales

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	1.8	4.2	4.5	4.8	5.2	20.5	52.5

Source: Joint Committee on Taxation.

U.S. multinational corporations generally pay U.S. tax on their worldwide income, including the income they earn from operations of their branches or subsidiaries in other nations. Foreign nations also tax the income from those operations, and the U.S. tax code allows multinational firms to take a limited credit for that foreign income tax. The credit is applied against what the firms would have owed in U.S. taxes on that income, but it cannot exceed what they would have owed if the income had been earned in the United States. If a corporation pays more foreign tax on its foreign income than it would have paid on otherwise identical domestic income, it accrues what the tax code calls excess foreign tax credits.

In contrast to income generated by operations abroad, the income corporations earn from products that are sold abroad but produced domestically results almost entirely from value created or added in the United States. Hence, the income that U.S. firms receive from exports typically is not taxed by foreign nations. But the tax code's "title passage" rule specifies that the source of a gain on the sale of a firm's inventory is the place to which the legal title to the inventory "passes." If a firm exports its inventory abroad, the title passage rule allocates the income from those sales in a way that, in effect, sources half of it to the jurisdiction in which the sale takes place and half to the place of manufacture. In practice, that means that if the firm's inventory is manufactured in the United States and sold abroad, half the income from the sale is still treated as though it were foreign in source—even though the firm may have no branch or subsidiary located in the place of sale and the foreign jurisdiction does not tax it.

The upshot of this rule is that a firm can classify more of its income from exports as foreign in source than could be justified solely on the basis of where the underlying economic activity occurred. A multinational firm with excess foreign tax credits can then use those credits to offset U.S. taxes on that foreign income. As a result, about half of the export income received by companies with such credits is effectively exempted from U.S. tax, and the income allocation rules essentially give U.S. multinational corporations an incentive to produce goods domestically for sale by their overseas subsidiaries.

This option would replace the title passage rule with one that apportioned income for the purpose of taxation on the basis of where a firm's economic activity actually occurred. The change would increase revenues by $1.8 billion in 2004 and $20.5 billion over the 2004-2008 period.

Export incentives, such as those embodied in the title passage rule, do not boost overall levels of domestic investment and employment, nor do they affect the trade balance. They increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. But the U.S. dollar appreciates as a consequence, making foreign goods cheaper and thereby reducing profits, investment, and employment for U.S. firms that compete with imports. Export incentives, therefore, distort the allocation of resources so that the prices of the goods they affect no longer reflect the goods' production costs (either domestically or abroad).

Foreign tax credits granted under U.S. tax law were intended to prevent business income from being taxed both domestically and abroad. But the title passage rule allows export income that is not usually subject to foreign tax to be exempted from U.S. taxes as well—which means that the income escapes business taxation altogether. Hence, allowing multinational corporations to use foreign tax credits to offset the U.S. taxes they would otherwise owe on export income may be an inappropriate use of such credits.

Opponents of eliminating the title passage rule base their position on a perceived need to provide U.S. corporations with an advantage over foreign corporations that operate in the same markets. However, corporations without excess foreign tax credits receive no advantage. Thus, the rule gives U.S. multinational exporters a competitive advantage over U.S. exporters that conduct all of their business operations domestically (and it gives U.S. multinational exporters that have excess foreign tax credits an advantage over those that do not).

RELATED CBO PUBLICATION: *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

Revenue Option 17

Make Foreign Subnational Taxes Deductible Rather than Creditable

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	2.6	6.0	6.3	6.6	6.9	28.4	67.4

Source: Joint Committee on Taxation.

Under current law, U.S.-owned corporations deduct state and local income taxes from their taxable income. However, they receive tax credits—a more favorable tax treatment in this instance than deductions—for income taxes that they pay to foreign governments, including foreign subnational governments such as foreign states, cities, and provinces. This option would treat income tax payments to foreign subnational governments the way payments to domestic state and local governments are treated. That change would increase tax revenues by $2.6 billion in 2004 and $28.4 billion over the 2004-2008 period.

Specifically, this option would continue to allow corporations to receive a credit for foreign taxes provided that those taxes exceeded a fixed percentage of either their foreign-source income or their foreign income taxes. That percentage would be set to reflect the overall ratio of state and local to federal income taxes within the United States. Taxes for which credits were denied would be deducted from a corporation's foreign-source gross income to yield its foreign-source taxable income. The option could be structured to either defer to or override existing tax treaties between the United States and foreign governments that call for other kinds of tax treatment.

Proponents of this option would probably argue that its main benefit would be to level the playing field between domestic and foreign investment. The option would accomplish that by reducing the slight incentive that U.S.-based multinational corporations now have to invest more abroad than at home, particularly in countries where the overall level of foreign income tax on a foreign investment is lower than the combined U.S. federal, state, and local taxes on a domestic investment. In turn, equalizing the tax treatment of foreign and domestic investment would allocate capital more efficiently worldwide.

In some respects, however, removing the creditability of income taxes paid to foreign subnational governments would have drawbacks. The option would make U.S. corporations operating in a foreign country less competitive with other foreign companies operating there and would probably lead some firms to repatriate less income from prior overseas investments to avoid paying the additional U.S. tax. Furthermore, if foreign countries implemented similar rules for taxing income that their corporations earned in the United States, those firms might curtail their U.S. investments, and the amount of capital flowing into the United States might decline.

RELATED CBO PUBLICATION: *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

Revenue Option 18

Set the Corporate Tax Rate at 35 Percent for All Corporations

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	2.4	3.7	3.7	3.4	3.0	16.2	32.1

Source: Joint Committee on Taxation.

Under current law, so-called C corporations pay taxes on their income under a progressive schedule of four explicit marginal tax rates: 15 percent, 25 percent, 34 percent, and 35 percent. (The marginal rate is the percentage of an extra dollar of taxable income that a corporation must pay in taxes.) This option would tax all corporate taxable income at the single statutory rate of 35 percent, raising $2.4 billion in revenues in 2004 and a total of $16.2 billion from 2004 through 2008. (Of note is that replacing the current rate structure with the maximum rate would make debt financing more favorable than equity financing for those firms that are subject to a higher rate. As a result, this option might have some repercussions on how firms raise capital.)

Under the progressive structure, corporate taxable income below $50,000 is currently taxed at the 15 percent rate. Taxable income from $50,000 to $75,000 is taxed at 25 percent, and income from $75,000 to $10 million is subject to a 34 percent rate. Corporations pay the top tax rate of 35 percent on taxable income in excess of $10 million. But additional taxes are added to the explicit rates, which reduces the progressivity of the tax structure. As a result, firms with taxable income of $18.3 million or more pay an average tax of 35 percent and receive no benefit from the progressive rate structure.

The progressive rate schedule for the corporate income tax was designed to encourage entrepreneurship and to provide some tax relief to businesses with small and moderate levels of profit. Of the approximately 1 million corporations that have positive corporate tax liabilities each year, only a few thousand do not benefit from the schedule's reduced rates. Yet those few thousand firms earn approximately 80 percent of all corporate taxable income.

People who might favor this option would argue that corporations other than small and medium-sized firms receive favorable treatment under the progressive rate structure. For example, the structure allows large corporations to shelter income or control the timing of income and expenses to reduce their taxable income for certain years. With the exception of owners of personal services corporations (such as physicians, attorneys, and consultants), whose firms are taxed at a flat rate of 35 percent, individuals can also benefit by sheltering income in the form of retained earnings in a small corporation.

Another argument against a progressive rate structure is that it favors firms that may have relatively low profits because they are inefficient. Except in the case of new or small firms, low profits may imply a low return on capital investment.

The earnings of C corporations are taxed twice, first at the corporate level and then at the individual level, if earnings are distributed to shareholders as dividends. Proponents of a progressive rate structure argue that it lessens the effect of that "double taxation." Corporations may be able to avoid double taxation by operating either as an S corporation or as a limited liability corporation (LLC). Owners of such enterprises pay tax on total business income but at the rates of the individual income tax. However, the top individual rate is now above the corporate tax rate, making it relatively less advantageous for businesses that retain earnings to choose the S corporate form or that of an LLC.

Revenue Option 19

Repeal the "Lower of Cost or Market" Inventory Valuation Method

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.2	0.6	0.6	0.6	0.3	2.3	2.9

Source: Joint Committee on Taxation.

The lower of cost or market (LCM) method of inventory valuation provides favorable tax treatment to firms that use the first-in, first-out approach to identifying inventory. Under the LCM method, firms are allowed to deduct from their taxable income unrealized year-end losses on items in their inventory that have declined in value. (The losses are unrealized because the items have not actually been sold.) For items that have increased in value, they are permitted to defer taxes on unrealized gains until the year in which the items are sold. Similarly, under the subnormal goods method of valuing inventory, firms may deduct inventory losses that arise from damaged or imperfect goods (or from similar causes), even if those goods may be sold and income realized in later years.

This option would repeal the LCM and subnormal goods methods of inventory valuation over a three-year period and require all firms to value their inventories at cost. (Under the cost valuation method, firms must include in taxable income both the gains and losses from any changes in the value of inventory when the goods are sold.) The option would increase revenues by $0.2 billion in 2004 and a total of $2.3 billion from 2004 through 2008.

Inventory valuation is an integral component of determining a firm's taxable profits, which in accounting terms are the difference between its receipts and the cost of the goods that it has sold. Under the accrual method of accounting, which firms typically use, the cost of goods sold is calculated by adding the value of the inventory at the beginning of the year to the cost of goods purchased or produced during the year and then subtracting from that total the value of the inventory at the end of the year. Firms may use either the LCM method or the cost method to value their inventory.

Under the LCM method, the market value of each item in a firm's inventory is compared with its cost; the lower of the two values must be used for that item. The value of a firm's inventory will be lower under the LCM method than under the cost method if the market value of any inventory item is below its cost. But the reverse is not true: inventory items that have appreciated in value over the year are still valued at their original cost. Using the resulting lower value for a firm's year-end inventory increases the cost of goods sold for a firm and lowers its taxable profits. In contrast, under the cost method of inventory valuation, gains and losses from changes in the value of inventory are included in taxable income only when the goods are sold.

Opponents of repealing the LCM method of inventory valuation argue that for firms that incur inventory losses without gains to offset them, the method provides a "cushion" during economic downturns or periods of uncertainty created by shifts in markets. A taxpayer with inventories that have dropped in value has incurred an economic loss. If that loss is deferred (not accounted for) until the inventory is subsequently sold, the taxpayer may be viewed as being overtaxed.

For firms that experience both inventory gains and losses, the LCM method provides favorable tax treatment. The asymmetric treatment of the gains and losses—firms can recognize losses without counting comparable gains—gives the LCM method a tax advantage over the cost method of accounting. As a result, a firm may claim a deduction for certain inventory losses even if the value of its entire inventory has increased. The LCM method has two other features that may offer unwarranted advantages to taxpayers that use it. First, once a firm has reduced the value of its inventory, current law does not require it to record an increase if market values subsequently rise. Second, market values under the LCM method are based on the replacement cost of inventory items, not on their resale value. Thus, the method allows a firm to reduce the value of inventory items if their replacement cost has declined—even though the firm may still be able to sell the inventory at a profit.

Revenue Option 20

Reduce Tax Credits for Rehabilitating Buildings, and Repeal the Credit for Nonhistoric Structures

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.2	0.2	0.2	0.2	0.2	1.0	2.4

Source: Joint Committee on Taxation.

The Congress has enacted tax credits for rehabilitating buildings to induce people to preserve historic structures, prompt businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit is 10 percent of expenditures on commercial buildings built before 1936 and 20 percent of expenditures on commercial and residential buildings that the Department of the Interior has certified as historic structures because of their architectural significance. This option would reduce the credit for historic structures to 15 percent and repeal the credit for nonhistoric structures, which would increase revenues by $0.2 billion in 2004 and by about $1.0 billion over the 2004-2008 period. Repealing both credits would raise about $2.5 billion over the same period.

Proponents and opponents of this option could mount several arguments to support their positions. On the one hand, proponents might say that the credits favor commercial structures over most rental housing and may therefore distort the allocation of capital. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining additional housing and commercial buildings. On the other hand, the option's opponents might contend that the credit may have social benefits when it encourages people to rehabilitate historically noteworthy buildings. The government could promote that objective at a lower cost, however, by permitting a credit only for renovating certified historic buildings and by lowering the credit's rate. Some surveys indicate that a credit of 15 percent would be sufficient to cover the extra costs involved in undertaking rehabilitation that satisfied regulatory standards for historic preservation.

Revenue Option 21

Tax Large Credit Unions Like Other Thrift Institutions

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.6	1.0	1.1	1.1	1.2	5.0	12.0

Source: Joint Committee on Taxation.

Credit unions are nonprofit institutions that provide their members with financial services—for example, they accept deposits and make loans. Originally, they were designed to be cooperatives whose members shared a common bond—in most cases, the same employer or the same occupation. Partly as a consequence of that distinction, federal income tax law treats credit unions more favorably than competing thrift institutions, such as savings and loans and mutual savings banks, by exempting their retained earnings from taxation. (Retained earnings are the portion of net income that credit unions reserve rather than pay out in dividends to members.) This option would tax the retained earnings of large credit unions —those with more than $10 million in assets—similarly to the way retained earnings of other thrift institutions are taxed, but it would permit small credit unions (less than $10 million in assets) to retain their tax-exempt status. The option would raise $0.6 billion in revenues in 2004 and a total of $5.0 billion from 2004 through 2008.

Initially, the retained earnings of credit unions, savings and loans, and mutual savings banks were all tax-exempt. In 1951, however, the Congress eliminated the exemptions for savings and loans and mutual savings banks on the grounds that they were similar to profit-seeking corporations. Since that time, large credit unions have come to resemble other thrifts. Beginning in 1982, credit union regulators have allowed a credit union to extend its services (subject to some restrictions) to members of organizations other than the one for which it was founded. In addition, most credit unions allow members and their families to participate even after a member has left the sponsoring organization.

The result of that relaxation of restrictions is that membership in credit unions has grown from about 5 million in 1950 to about 70 million today. Large credit unions, like taxable thrifts, now serve the general public and provide many of the services offered by savings and loans and mutual savings banks. A significant number of credit unions offer mortgages and car loans, access to automatic tellers, credit cards, individual retirement accounts, and discount brokerage services. They also resemble thrift institutions in that they retain earnings.

Proponents of taxing the retained earnings of large credit unions similarly to the way earnings of other large thrift institutions are taxed might argue for it on the basis of efficiency. Similar tax treatment of like institutions promotes competition and the provision of services at the lowest cost. Proponents might also raise the issue of equity: other thrift institutions contend that credit unions use their retained earnings to finance expansion.

Small credit unions are more like nonprofit organizations than like their larger counterparts, which supports the argument that their retained earnings should be tax-exempt, as those of nonprofit organizations are. Like those nonprofits, most small credit unions have members with a single common bond or association. And in some cases, their organizations are rudimentary: volunteers from the membership may manage and staff the credit union, and the level of services may not be comparable with what other thrifts offer. Allowing small credit unions to retain their tax exemption for retained earnings would affect 8 percent of all assets in the credit union industry and about two-thirds of all credit unions. However, a difficulty encountered in taxing the assets of large credit unions but allowing the assets of small ones to remain tax-exempt is that the $10 million cutoff in asset size could be viewed as arbitrary.

Revenue Option 22

Repeal the Expensing of Exploration and Development Costs for Extractive Industries

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	2.9	3.9	3.0	2.1	1.2	13.1	15.7

Source: Joint Committee on Taxation.

Through various tax incentives, the current tax system treats extractive industries (producers of oil, gas, and minerals) more favorably than most other industries (see Revenue Option 23). One incentive designed to encourage exploration and development of certain types of oil, gas, and hard minerals allows producers of those commodities to "expense" some of their exploration and development costs (deduct them from their taxable income when they are incurred) rather than capitalize them (deduct them over time as the resulting income is generated). Eliminating the expensing of those costs would raise $2.9 billion in revenues in 2004 and a total of $13.1 billion from 2004 through 2008. (The option incorporates the assumption that firms could still expense some of their costs, specifically those from unproductive wells and mines.)

Immediately deducting costs contrasts with the tax treatment that other industries face, in which costs are deducted more slowly, according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs related to property to be either deducted when the property is sold or recovered over several years as depreciation. (In both cases, the deducting of costs is postponed.) However, so-called intangible costs (for example, maintenance of working capital) related to drilling and development and costs for mine development and exploration are exempt from those rules. Thus, the expensing of such costs provides an incentive for extractive industries that other industries do not have. (See Revenue Options 25 and 26 for other exceptions.)

Costs for exploration and development that extractive firms can expense include costs for excavating mines, drilling wells, and prospecting for hard minerals—but not for oil and gas. Although current law allows independent oil and gas producers and noncorporate mineral producers to fully expense their costs, it limits expensing to 70 percent of costs for "integrated" oil and gas producers (companies involved in substantial retailing or refining activities) and corporate mineral producers. Firms subject to the 70 percent limit must deduct the remaining 30 percent of their costs over 60 months.

The rationale for expensing the costs of exploration and development has shifted from its original focus. When the incentive was put in place, the argument was that such costs were ordinary operating expenses. Today, advocates of continuing the incentive justify it on the grounds that oil and gas are "strategic minerals," essential to national energy security. But expensing works in several ways to distort the allocation of resources. First, it causes resources to be allocated to drilling and mining that might be used more productively elsewhere in the economy. Second, although the incentive might make the United States less dependent on imported oil in the short run, it encourages producers to extract more now—perhaps at the cost of extracting less in the future and having to rely more on foreign production. Third, expensing may result in production being allocated inefficiently within these extractive industries. Inefficiency may occur because the magnitude of the incentive varies depending on factors that are not systematically related to economic productivity—such as the difference between the immediate deduction and the true useful life of the capital—as well as on whether the producer must pay the alternative minimum tax (in which case expensing is limited).

RELATED OPTIONS: 300-03; Revenue Options 23, 24, 25, and 26

RELATED CBO PUBLICATION: *Reforming the Federal Royalty Program for Oil and Gas*, November 2000

Revenue Option 23

Repeal Percentage Depletion for Extractive Industries

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.1	0.2	0.2	0.2	0.2	0.9	2.3

Source: Joint Committee on Taxation.

The current tax system in various ways favors extractive industries (producers of oil, gas, and minerals) over most other industries. One way is by allowing producers to deduct immediately, rather than over time, the costs they incur for exploration and development (see Revenue Option 22). Another is by allowing some firms to use the "percentage depletion" method to recover their costs rather than the standard "cost depletion" method. This option would repeal percentage depletion, raising $0.1 billion in revenues in 2004 and about $0.9 billion over the 2004-2008 period.

The percentage depletion method of cost recovery is a tax incentive provided to certain types of extractive companies—independent producers, owners of royalties, and "nonintegrated" firms (companies that are not involved in substantial retailing or refining activities). The tax code allows those firms to deduct from their taxable income a certain percentage of a property's gross income in each taxable year, regardless of the property's actual capitalized costs (that is, the deduction that should occur over time). In contrast, other industries (and, since 1975, integrated oil companies as well) use the cost depletion method. Under that approach, the costs that a firm recovers cannot exceed its expenses for acquiring and developing the property; under percentage depletion, they may. Thus, the percentage depletion method treats certain types of extractive companies more favorably than others. Unlike the expensing of exploration and development costs, however, percentage depletion applies only to a small portion of total oil, gas, and minerals production because it excludes the large integrated producers.

Current law typically allows nonintegrated oil and gas companies to deduct 15 percent of their gross income from producing oil and gas, up to a ceiling of the income from 1,000 barrels per day. But the Omnibus Budget Reconciliation Act of 1990 made percentage depletion even more generous for nonintegrated companies that are considered "marginal" producers (those with very low total production or production entirely made up of heavy oil). The deduction for marginal properties can be up to 25 percent of gross income if the price of oil drops low enough. Producers of hard minerals may also use percentage depletion, but the statutory deduction percentages vary from 5 percent to 22 percent, depending on the type of mineral. Tax law limits the amount of percentage depletion to 100 percent of the net income from a property with oil and gas and 50 percent of the net income from a property with hard minerals.

Percentage depletion has been justified on the grounds that oil and gas are "strategic minerals," essential to national energy security. But that method of recovering costs distorts the allocation of resources by encouraging more production in the oil and gas industry than among other types of firms. And, like expensing, percentage depletion can cause extractive businesses to allocate their resources inefficiently—for example, by developing existing properties rather than exploring for and acquiring new ones.

RELATED OPTIONS: 300-03; Revenue Options 22 and 24

RELATED CBO PUBLICATION: *Reforming the Federal Royalty Program for Oil and Gas*, November 2000

Revenue Option 24

Repeal the Tax Credit for Enhanced Oil Recovery Costs, and Eliminate the Expensing of Tertiary Injectants

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.5	0.7	0.6	0.6	0.6	3.0	5.8

Source: Joint Committee on Taxation.

Oil producers currently receive a tax credit of 15 percent against their costs for recovering domestic oil by a qualified "enhanced oil recovery" (EOR) method. Qualifying methods are those that allow producers to recover oil that is too viscous to be extracted by conventional methods. The costs of labor, materials, equipment, repairs, and development as well as so-called intangible costs related to drilling qualify for the credit, which phases out when oil prices rise above $28 per barrel (adjusted for inflation).

The tax code also provides another incentive related to viscous oil. It allows producers to "expense" the costs of tertiary injectants—the fluids, gases, and other chemicals that are injected into oil or gas reservoirs to extract highly viscous oil. Producers may deduct the full cost of those chemical injectants in the year in which they are used to extract oil. The expenditures for injectants also qualify for the EOR credit; however, the credit must be subtracted from the deduction if both are claimed for the same expenditure. Eliminating both the EOR credit and the expensing of tertiary injectants would increase revenues by $0.5 billion in 2004 and $3.0 billion over the 2004-2008 period.

The Congress enacted the EOR credit as part of the Omnibus Budget Reconciliation Act of 1990. It was designed to increase the domestic supply of oil and reduce the demand for imported oil, particularly from producers in the Persian Gulf and other politically unstable areas. Legislators enacted the expensing of tertiary injectants in 1980 for similar reasons. However, without the tax incentives provided by the credit and expensing, the use of tertiary injectants to extract oil would not be economical, and enhanced oil recovery would not be an economically viable extraction approach (because it is more expensive than recovering oil by conventional methods).

Advocates of retaining both provisions say they provide several benefits: they lower the cost of producing oil by unconventional, more-expensive methods and enable producers to increase the extractable portion of a reservoir's oil beyond the normal one-third to one-half. Increased domestic production lessens short-term dependence on foreign oil, but it also depletes domestic resources, encouraging long-term dependence on imports. Indeed, opponents of the tax incentives argue that these provisions are unlikely to reverse either the long-term slide that has occurred in domestic production or the nation's growing dependence on imports. They also contend that the United States is now less vulnerable to disruptions in supply because it stockpiles oil in the Strategic Petroleum Reserve and world oil markets have become increasingly competitive.

RELATED OPTIONS: 270-08; Revenue Options 22, 23, and 26

RELATED CBO PUBLICATION: *Climate Change and the Federal Budget*, August 1998

Revenue Option 25

Repeal the Partial Exemption from Motor Fuel Excise Taxes Now Given to Alcohol Fuels

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.8	0.8	0.9	0.9	1.0	4.4	9.8

Source: Joint Committee on Taxation.

The tax code imposes excise taxes on motor fuels, but it partially exempts from those levies fuels that are blends of gasoline and alcohol (and that as a result have a higher oxygen content than gasoline alone). Repealing that partial exemption would raise $0.8 billion in revenues in 2004 and $4.4 billion over the 2004-2008 period. Those estimates incorporate the assumption that the Congress would also repeal the alcohol fuels credit, which producers may claim instead of the partial excise tax exemption. In almost all cases, however, the credit is less valuable than the exemption and is rarely used.

The tax incentive that the exemption represents applies only to blends that use alcohol fuels produced from nonfossil, or renewable, sources. One such fuel is ethanol, which is made primarily from corn and sugar. When used as a fuel, ethanol is eligible for a nonrefundable reduction in the excise tax—through the credit or the exemption—of up to 53 cents per gallon. The magnitude of the reduction depends on the percentage of alcohol in the fuel. For example, the exemption for gasohol, which is 90 percent gasoline and 10 percent ethanol, is 5.2 cents per gallon from the excise tax on gasoline of 18.3 cents per gallon. (The exemption goes to the firm that blends the ethanol with the gasoline.) It was first enacted in the 1970s and was scheduled to expire at the end of fiscal year 1999. But the Transportation Equity Act of 1998 extended it while gradually lowering the maximum amount. Thus, the exemption drops to 5.2 cents per gallon for 2003 to 2004 and 5.1 cents per gallon for 2005 to 2007. The entire exemption for gasohol is now scheduled to expire at the end of fiscal year 2007.

The tax inducement had several main purposes when it was first enacted. One was to reduce the demand for imported oil, thereby lessening U.S. dependence on foreign sources. Another was to provide an additional market for U.S. agricultural products by encouraging firms to produce ethanol domestically. Judging by sales of the motor fuel blends, the tax incentive appears to have successfully encouraged energy producers to substitute ethanol for gasoline.

Today, as the incentive's supporters argue, the major justification for it is that using oxygenated fuels in motor vehicles generally produces less carbon monoxide pollution than using gasoline does. Those proponents might also point to the effect that repealing the incentive could have on federal outlays for price support loans for grains. Without the tax inducement to produce corn for ethanol, the price of corn might fall, which could lead the government to step in to help farmers. But any increase in outlays for price support loans, which is not included in the budget estimates for this option, would probably be much smaller than the projected boost in revenues from repealing the tax incentive.

Regulations now in place under the Clean Air Act Amendments of 1990, which mandate the minimum oxygen content of gasoline in areas with poor air quality, raise questions about the continued need for the incentive. Further contributing to those questions are actions by the Environmental Protection Agency, which support the use of ethanol to meet the standards for oxygen content by restricting the use in gasoline of MTBE (an alcohol fuel derived from fossil fuel sources). Another argument for repealing the exemption is that ethanol is more costly to produce than gasoline. The partial exemption might be economically inefficient if the added cost outweighed the value of the reduction in air pollution.

RELATED OPTIONS: 270-01, 270-03, and 270-07; Revenue Options 22 and 35

RELATED CBO PUBLICATION: *Reducing Gasoline Consumption: Three Policy Options*, November 2002

Revenue Option 26

Capitalize the Costs of Producing Timber

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.4	0.5	0.5	0.5	0.5	2.4	4.6

Source: Joint Committee on Taxation.

The current tax system allows timber producers to deduct from their taxable income, or "expense," most of the costs of maintaining a stand of timber when those costs are incurred. (Such expenses include disease and pest control, brush clearing, and indirect carrying costs such as interest on loans and property taxes.) That tax treatment contrasts with the uniform capitalization rules that apply to such costs in most other industries. (See Revenue Options 22 and 24 for other exceptions to the rules.) Established under the Tax Reform Act of 1986 (TRA-86), the uniform capitalization rules require that production costs be deducted only when goods or services are sold. When businesses are allowed to expense those costs (deduct them immediately), the effective tax rate on a producer's investment in them is zero. Thus, timber producers pay no tax on any income they use to cover those costs, and the tax code in effect favors timber production by deferring taxes that producers otherwise would owe on their income. (Under certain circumstances, however, the tax code limits losses from passive business activities, which may greatly curtail the deferral granted to noncorporate producers of timber.)

This option would capitalize costs incurred after December 31, 1999, for producing timber. It would raise $0.4 billion in revenues in 2004 and a total of $2.4 billion from 2004 through 2008 by accelerating tax payments from timber producers.

Various rationales have been offered for expensing the costs of timber production. The original justification was a general perception that such costs were for maintenance and thus deductible as ordinary costs of a trade or business. When TRA-86 established uniform capitalization rules for other industries, one reason given for exempting timber production was that applying the rules to that industry might have been unduly burdensome. But the exemption comes with an economic price. Allowing timber producers to expense their production costs distorts investing in two ways: more private land is devoted to timber production than might otherwise have been the case, and trees are allowed to grow longer before they are cut (because producers do not have to harvest them quickly to finance their costs). Those outcomes could be considered beneficial if timber growing offered spillover benefits to society that market prices did not take into account. Otherwise, the tax-favored treatment would lead to inefficiency in both the use of land and the rate of harvesting.

Whether timber production offers important spillover benefits is unclear. Standing timber provides some benefits by deterring soil erosion and absorbing carbon dioxide (a gas linked to global warming)—but producing and disposing of wood and paper products contribute to pollution.

In the short run, capitalizing the costs of timber production might lower the price of domestic timber because producers would have an incentive to harvest trees earlier. In the longer run, however, it would raise prices and lower the value of the land used to grow timber. Another effect of capitalizing costs is that lease payments to private landowners by timber growers would probably decline, causing some land that historically has been devoted to growing timber to be used in other ways.

RELATED OPTIONS: 300-01; Revenue Options 22 and 24

Revenue Option 27

Tax the Income Earned by Public Electric Power Utilities

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.5	0.7	0.7	0.7	0.8	3.4	7.6

Source: Joint Committee on Taxation.

The income that local governments earn from any public utility, including electric power facilities, is exempt from federal income tax. In contrast, the income of investor-owned utilities is taxable. Taxing the income of public facilities for generating, transmitting, and distributing electricity similarly to the income of investor-owned facilities would raise $0.5 billion in revenues in 2004 and a total of $3.4 billion from 2004 through 2008.

In the past, electricity was provided by local monopolies, in part to take advantage of cost-saving economies of scale. Some of those utilities were public facilities, which developed for a variety of reasons. For example, public facilities offered a feasible alternative in geographic areas where low population density caused the cost of power per customer to be high and private producers were reluctant to enter a market in which the potential for profit appeared inadequate. Public utilities also developed in areas where citizens, worrying that a private provider might exploit its position as a monopoly, wanted to ensure that electricity would be available to all residential consumers at a reasonable cost.

But times and circumstances change. States are in varying stages of deregulating electric power generation, in part because improved technologies have lessened the importance of economies of scale and in part because electric service is almost universal in this country, even in areas of low population density. And the competition that the industry's restructuring brings, say advocates of this option, will protect consumers from monopolistic pricing by private firms.

Proponents of this option would contend that economic and technological changes, combined with the fact that approximately 75 percent of electric power is already provided by the private sector, cast doubt on the benefits society receives from public-sector involvement in this market. Even less clear are the benefits that federal taxpayers receive from treating the earnings of public providers of electricity more favorably than the earnings of private providers. Proponents might also argue that taxing publicly owned electric power facilities will spur competition, result in consumption of an economically efficient amount of public power, and preserve the corporate tax base.

One argument for exempting public power's income from taxation has been that it is a way to keep the price of power low and thus reduce the power costs of lower-income people. But treating public utilities' income more favorably than other utilities' is an inefficient way of accomplishing that. The federal government helps lower-income groups more directly with programs such as the Low Income Home Energy Assistance Program of grants to the states.

Taxing the income of public electric utilities might adversely affect consumers in some communities who rely on that source for their power. The tax would cause the price of publicly provided electricity to rise, and public utilities that found themselves uncompetitive might have to shut down some facilities that were inefficient. If those facilities were being financed with debt that had not yet been retired, state and local taxpayers could be left with significant costs. Further complicating a change such as the one described in this option are the numerous legal and practical issues that would have to be resolved if the federal government taxed income earned from what might be termed business enterprises of state and local governments.

RELATED OPTIONS: 270-05, 270-06, and 270-09; Revenue Options 30 and 31

Revenue Option 28

Tighten Rules on Interest Deductions for Corporate-Owned Life Insurance

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.2	0.5	0.5	0.6	0.6	2.4	5.8

Source: Joint Committee on Taxation.

Corporations purchase life insurance policies in part to protect their firms against financial loss in case one or more of their important employees or owners dies. Purchases of life insurance that builds up a cash value provide a tax advantage if corporations pay the premiums on the policies indirectly (by increasing debt or other liabilities) and then deduct the interest they pay on that debt from their taxable income. The Internal Revenue Service will not allow corporations to deduct that interest if it can link a firm's increases in debt or other liabilities directly to its purchase of cash-value insurance. Establishing a direct connection is difficult, however, because firms increase their liabilities for many purposes.

This option would disallow a proportion of a firm's total deductions for interest equal to the proportion of its total assets invested in cash-value life insurance policies. The option would not apply to insurance on the life of owners who had an interest of 20 percent or more in the firm. It would raise an estimated $0.2 billion in revenues in 2004 and $2.4 billion over the 2004-2008 period.

The tax code's asymmetrical treatment of the investment income that a corporation receives from life insurance policies and its costs in relation to those policies is the source of the tax advantage. First, tax law exempts the investment income (termed the "inside buildup") of a life insurance policy from corporate income tax. Second, it permits a corporation to deduct from its taxable income the interest on debt that is indirectly used to finance that investment. Such an approach opens the door to tax arbitrage (broadly, gaining advantage from asymmetrical treatment of gains and losses in the tax code) because corporations can generate interest deductions that they can then use to shelter other, taxable income. Individual taxpayers may not avail themselves of that advantage because the tax code does not allow them to deduct those interest payments.

Over the past several years, corporations have been restricted from using life insurance policies to shelter income. After 1996, they could no longer deduct the interest on loans from an insurance company that used the cash-value policy as collateral. (An exception was made, however, for insurance on certain key employees.) In 1997, the Congress and the President enacted a law that disallowed a proportion of a corporation's interest deductions, but the law applied only to firms that purchased cash-value insurance on the lives of people who were not employees or owners. This option would further prohibit such deductions except for purchases of insurance on the lives of people who own at least 20 percent of a firm. (This kind of disallowance has been used in other contexts as well. In 1986, a proportion of interest deductions was disallowed for financial institutions that purchase debt issued by state and local governments whose interest is tax-exempt.)

Opponents of this option argue that a firm may have legitimate business reasons to purchase life insurance policies on its employees and owners as well as other business reasons to issue debt, and that the firm may not be linking the two decisions to create a tax shelter. Proponents of the option argue, however, that firms in most cases intend to use the policies and debt to shelter income from taxation.

Revenue Option 29

Repeal Tax-Free Conversions of Large C Corporations to S Corporations

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.1	0.1	0.1	0.1	0.1	0.5	1.0

Source: Joint Committee on Taxation.

For tax purposes, the predominant forms of business enterprise are C corporations, S corporations, partnerships, and sole proprietorships. Under current law, a C corporation may reduce taxes on some of its income by electing to be treated as an S corporation or by converting to a partnership. The income of C corporations faces a two-tiered corporate tax; that is, it is generally taxed twice—once when it is earned by the corporation and again when it is distributed to stockholders. Income received by S corporations and partnerships, in contrast, is taxed only once, at the individual income tax rates of the firms' owners.

Over time, the distinction between S corporations and partnerships has blurred. Nevertheless, a C corporation that elects to change its tax filing status to that of an S corporation is treated more favorably than a C corporation that converts to a partnership. Converting to an S corporation is tax-free in many circumstances. Converting to a partnership is taxable; it requires the corporation to "recognize" (include in its taxable income) any built-in gain on its assets and requires shareholders to recognize any such gain in their corporate stock. Under section 1374 of the Internal Revenue Code, if a C corporation converts to an S corporation, the appreciation of the firm's assets while it was a C corporation is not subject to the corporate-level tax—unless the assets are sold within 10 years of the conversion. Thus, current law allows a C corporation to avoid the two-tiered corporate tax by converting tax-free to an S corporation.

This option would repeal tax-free conversions for corporations with a value of more than $5 million at the time of conversion. Thus, when a C corporation with a value of over $5 million converted to an S corporation, the corporation and its shareholders would immediately recognize the gain in their appreciated assets. This option would increase income tax revenues by $0.1 billion in 2004 and $0.5 billion over the 2004-2008 period.

Proponents of this option might argue that repealing tax-free conversions by C corporations would treat economically similar conversions—from two-tiered corporate tax systems to single-tiered systems—in the same way. That equalization would, in turn, make tax considerations less important in decisions about the legal form that a firm might take. However, people who think S corporations more closely resemble corporations than they do partnerships might consider it beneficial to preserve the current differential tax treatment. According to that viewpoint, current law merely allows a corporation to change its filing status from that of a C corporation to that of an S corporation, providing it meets the legal requirements, without having to pay tax for choosing a different corporate form.

Revenue Option 30

Tax the Income of Cooperatively Owned Electric and Telephone Utilities

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.1	0.1	0.1	0.1	0.1	0.5	0.8

Source: Joint Committee on Taxation.

Electric and telephone cooperatives, which are owned by their customers, are effectively or explicitly exempt from the corporate income tax. They pay no tax on the portion of their income that they are required to distribute as dividends to their members, and they pay no tax on earnings from other sources, as long as at least 85 percent of their income comes from members for providing their primary service (electricity or telephone). Moreover, some forms of outside income—including rental income from telephone poles that are leased to cable or telephone companies and income from the Yellow Pages, cable TV, and Internet access—are not even counted toward the remaining 15 percent.

Eliminating those exemptions, which essentially treat electric and telephone cooperatives more favorably than privately owned electric and telephone utilities, and taxing the co-ops as ordinary for-profit corporations would raise $0.1 billion in 2004 and $0.5 billion over the 2004-2008 period. In addition to exempting the co-ops' income from the corporate income tax, current law does not levy taxes on their distributions of dividends to members—whether as cash or as payments in kind in the form of household utility services. Eliminating that exemption could generate additional revenues.

The tax breaks given to co-ops, along with the low-interest loan program available through the Rural Utilities Service, were created to encourage the wiring of rural areas for service. But now that most of the nation has telephone service, and the use of cell phones is widespread, there is little justification for the co-ops' tax-favored status. As for electricity, most of the United States is already connected to the nationwide electricity grid, and the cost to distributors of providing electricity is probably the same for rural and urban customers. Moreover, the income of all electric cooperatives is exempted from taxation—even that of generation cooperatives, which do not need the favorable treatment (because generating electricity does not cost more in rural areas). Finally, the market for electricity has been partially deregulated in the past few years. Continuing to provide this tax exemption in a more competitive environment gives cooperatives an advantage over utilities that are investor owned and that pay corporate income taxes.

Arguing against this option are its potential consequences for the co-ops' customers. If the tax exemption was withdrawn and cooperatively owned electric and telephone utilities had to pay the same corporate income tax that other suppliers of electricity pay, rates might increase for the cooperatives' customers. Ending the exemption would also raise issues related to equity. Subjecting electric and telephone co-ops to taxes that most other co-ops do not pay would treat some kinds of firms more favorably than other, similar operations.

RELATED OPTIONS: 270-05, 270-06, and 270-09; Revenue Options 27 and 31

RELATED CBO PUBLICATIONS: *Electric Utilities: Deregulation and Stranded Costs*, October 1998; and *Should the Federal Government Sell Electricity?* November 1997

Revenue Option 31

Eliminate the Exemption of Interest Income on Debt Issued by State and Locally Owned Electric Utilities for New Generating or Transmitting Facilities

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	*	0.1	0.1	0.2	0.2	0.6	2.3

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

State and locally owned utilities, as well as a small number of investor-owned utilities, issue tax-exempt bonds to finance the generation and transmission of electricity. Because the interest that utilities pay on those bonds is not taxed, investors are willing to accept a lower yield than they would otherwise require to purchase those securities. By allowing some utilities to finance new generating and transmitting facilities through tax-exempt bonds, the tax code treats those utilities more favorably than some others—for example, most cooperatively or investor-owned utilities that must issue taxable debt, on which investors require a higher rate of interest. This option would eliminate the exemption and tax the interest earned on bonds used by state and locally owned utilities to finance new generating or transmitting facilities. The option would raise about $0.6 billion over the 2004-2008 period.

State and locally owned utilities also use tax-exempt bonds to finance the distribution and retailing of electricity. This option does not apply to bonds for those purposes, although eliminating those tax exemptions could generate additional revenues. The option also does not apply to outstanding bonds that were used to finance existing generating and transmitting facilities.

The market for electricity is becoming increasingly competitive. Many states have already deregulated the generation sector of the electricity industry, allowing customers to choose their electricity supplier. More states are expected to deregulate in the future. Utilities that have access to tax-exempt financing have a lower cost of capital than do other providers of electricity. By using that lower-cost capital to cut prices to their customers, such utilities not only encourage consumers to use more electricity than they would otherwise have used but also gain an advantage over other utilities in competing for customers. Utilities that had access to lower-cost capital and did not use it to cut prices would probably use it to subsidize other public services or support inefficient techniques for producing electricity.

Opponents of eliminating the tax exemption argue that if it ended and state and locally owned utilities paid the same interest rate to attract capital for generation and transmission that other electricity suppliers pay, the rates charged for electricity by publicly owned utilities might rise. In addition, some people argue that the low cost of capital is necessary to finance universal service or affordable electricity rates for some disadvantaged groups.

RELATED OPTIONS: 270-05, 270-06, and 270-09; Revenue Options 27 and 30

RELATED CBO PUBLICATION: *Causes and Lessons of the California Electricity Crisis*, September 2001

Revenue Option 32

Apply the Limited Depreciation Schedule to All Business-Use Sport Utility Vehicles and Automobiles

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.2	0.3	0.3	0.2	*	1.0	1.3

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

Taxpayers are generally allowed to recover the cost of depreciable business property under the tax code's modified accelerated cost recovery system. They may also, under certain circumstances, expense rather than depreciate the first $25,000 of the cost of depreciable property —that is, deduct it from taxable income in the year in which the property is placed in service, rather than over time, in scheduled increments. In addition, current law provides a temporary 30 percent expensing allowance for most depreciable equipment that is acquired after September 10, 2001, and before September 11, 2004.

But the cost recovery for vehicles with a loaded gross vehicle weight (GVW) under 6,000 pounds is generally subject to scheduled limits on those deductions. For tax year 2002, the depreciation limits were $3,060 in the first tax year (or $7,660, if the temporary 30 percent depreciation allowance applied); $4,900 in the second year; $2,950 in the third year; and $1,775 in each additional year. (Those amounts are indexed for inflation as measured by the consumer price index for automobiles.) As a result of those limits, the cost of acquiring a business-use automobile does not usually qualify for the full tax-favored treatment of expensing and accelerated depreciation.

However, the depreciation limits do not apply to vehicles with a loaded GVW of more than 6,000 pounds—a category that includes most sport utility vehicles (SUVs) and light trucks—whose cost can therefore be written off at a much faster rate. With that differential treatment, the tax code provides an incentive for business car buyers to purchase SUVs or other such heavy vehicles (that is, with a loaded GVW of more than 6,000 pounds) when they might otherwise have purchased smaller automobiles.

This option would apply the limited depreciation schedule to all business-use SUVs and automobiles regardless of weight but would not change the tax treatment of other types of vehicles with a loaded GVW of more than 6,000 pounds. The option would raise $0.2 billion in revenues in 2004 and $1.0 billion over the 2004-2008 period.

Proponents of this option argue that SUVs are rarely needed for business use and that the option would increase economic efficiency by eliminating the tax incentive for businesses and self-employed individuals to purchase them instead of smaller vehicles. Because heavy SUVs tend to emit more pollutants and have lower gas mileage than lighter vehicles, this option would also reduce pollution and the consumption of fossil fuels.

Opponents of this option would argue that the differential tax treatment accorded to heavy SUVs used for business was appropriate in some cases (because the operations of some firms require that type of vehicle). Other opponents might also point out that this option does not eliminate the incentive for businesses and self-employed individuals to purchase other vehicles with loaded GVWs exceeding 6,000 pounds, even though a smaller, less-polluting vehicle might be an acceptable alternative in those cases as well.

Revenue Option 33

Increase the Excise Tax on Cigarettes by 50 Cents per Pack

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	6.6	6.5	6.5	6.6	6.6	32.8	65.5

Source: Joint Committee on Taxation.

Taxes on certain goods and services can influence consumers' choices, leading people to purchase less of the taxed items than they might have otherwise. That taxation generally leads to a less efficient allocation of society's resources—unless some of the costs associated with the taxed items are not reflected in their price.

Tobacco is one such product that creates "external costs" to society that are not covered in its pretax price—for example, higher costs for health insurance to cover the medical expenses linked to smoking and the effects of cigarette smoke on the health of nonsmokers. But taxes increase prices and can result in consumers' paying the full cost (including the external costs) of smoking. Increased taxes have also been shown to reduce the consumption of tobacco. Researchers estimate that each 10 percent increase in cigarette prices is likely to lead to a decline in cigarette consumption of 2.5 percent to 5 percent, with probably a larger decline for teenagers.

Tobacco is taxed by both the federal government and the states. Currently, the federal cigarette excise tax is 39 cents per pack; other tobacco products are subject to similar levies. In recent years, state excise taxes have increased from an average of 42 cents per pack in 2000 to an average of about 54 cents per pack in 2002. In addition, settlements reached between state attorneys general and major tobacco manufacturers require payments of fees equal to an excise tax of about 50 cents per pack. Federal tobacco taxes raised about $7.4 billion in fiscal year 2001, or about 0.4 percent of total federal revenues.

This option would increase the federal excise tax on cigarettes by 50 cents per pack. It would generate $6.6 billion in added revenues in 2004 and a total of $32.8 billion from 2004 to 2008.

No consensus exists about the magnitude of the external costs of smoking, which makes it difficult to judge the efficiency of tobacco taxes. Some economists estimate that the external costs of smoking are significantly less than the taxes and settlement fees now levied on tobacco. Other analysts think that the external costs are greater and that taxes should be boosted even more. Technical issues cloud the debate; for example, the effect of secondhand smoke on people's health is uncertain. Much of the controversy centers on varying theories about what to include in figuring external costs—such as whether to consider tobacco's effects on the health of smokers' families or the savings in spending on health care and pensions that result from smokers' shorter lives. Nevertheless, an increase in excise taxes on cigarettes may be desirable, regardless of the size of the external costs, if consumers underestimate the harm done by smoking or the addictive power of nicotine. Teenagers in particular may not be prepared to evaluate the long-term effects of beginning to smoke, although all groups know that smoking has health risks.

Arguing against taxes on tobacco is their regressivity; that is, such taxes take up a greater percentage of the earnings of low-income families than of middle- and upper-income families. That imbalance occurs because lower-income people are more likely than other income groups to smoke and because expenditures on cigarettes by people who smoke do not rise appreciably with income.

RELATED CBO PUBLICATIONS: *The Proposed Tobacco Settlement: Issues from a Federal Perspective*, April 1998; and *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990. (The proposal discussed in the former publication does not reflect the final settlement.)

Revenue Option 34

Increase All Alcoholic Beverage Taxes to $16 per Proof Gallon

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	3.9	4.8	4.9	5.0	5.1	23.7	50.3

Source: Joint Committee on Taxation.

In terms of the federal excise tax per ounce of ethyl alcohol, current law treats alcoholic beverages in different ways. Levies remain much lower on beer and wine than on distilled spirits, and they are figured on different liquid measures. Distilled spirits are measured in proof gallons, a standard measure of a liquid's alcohol content; the current rate of $13.50 per proof gallon results in a tax of about 21 cents per ounce of alcohol. Beer, however, is measured by the barrel, and the current rate of $18 per barrel leads to a tax of about 10 cents per ounce of alcohol (assuming an alcohol content for beer of 4.5 percent). The current levy on wine is $1.07 per gallon and results in a tax of about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent). In fiscal year 2001, federal excise taxes on distilled spirits, beer, and wine brought in approximately $8 billion in revenues.

This option would standardize the base on which the federal excise tax is levied and use the proof gallon as the measure for all alcoholic beverages. It would also increase the tax to $16 per proof gallon, raising about $4 billion in 2004 and a total of almost $24 billion between 2004 and 2008. A tax of $16 per proof gallon comes to about 25 cents per ounce of ethyl alcohol. It would boost the tax on a 750-milliliter bottle of distilled spirits from about $2.14 to $2.54, the tax on a six-pack of beer from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of table wine from about 21 cents to 70 cents.

The consumption of alcohol creates costs to society that are not reflected in the pretax price of alcoholic beverages. Examples of those "external costs" include costs related to health care that are covered by the public, losses in productivity that are borne by others besides the alcohol consumer, and the loss of lives and property in alcohol-related accidents and crimes. Calculating such costs raises both practical and theoretical difficulties; however, a study reported by the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998.

Increasing the price of alcoholic beverages through a hike in excise taxes would reduce the external costs of alcohol use and lead alcohol consumers to pay a larger share of the costs of such consumption. Studies consistently show that higher prices lead to less consumption and less abuse of alcohol, even among heavy drinkers. Moreover, boosting excise taxes to reduce consumption may be desirable, regardless of the effect on external costs, if consumers are unaware of or underestimate either the harm that their drinking does to them and others or the extent of the addictive qualities of alcohol.

Yet taxes on alcoholic beverages have their downside as well. They are regressive when compared with annual family income; that is, such taxes take up a greater percentage of income for low-income families than for middle- and upper-income families. In addition, taxes on alcohol fall not only on problem drinkers but also on drinkers who impose no costs on society and are thus unduly penalized. Another consideration is that taxes may reduce consumption by some light drinkers whose intake of alcohol might produce beneficial health effects.

RELATED CBO PUBLICATION: *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990

Revenue Option 35

Increase Excise Taxes on Motor Fuel by 12 Cents per Gallon

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	15.3	15.4	15.6	16.1	16.6	79.0	170.6

Source: Joint Committee on Taxation.

Federal taxes on motor fuel, which are used to finance highway construction and maintenance, are currently 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel. This option would raise those taxes by 12 cents per gallon, increasing revenues by about $15 billion in 2004 and$79 billion over the 2004-2008 period. The total federal tax on gasoline under the option would be 30.4 cents per gallon.

Imposing new or higher taxes on petroleum could have several beneficial effects. For example, making petroleum more expensive could encourage conservation and reduce pollution. Higher prices might encourage people to drive less or to purchase more-fuel-efficient cars and trucks. Less consumption of motor fuel would also lower carbon dioxide emissions and could therefore help moderate human impacts on the global climate. A further benefit is that the tax would offset, though imperfectly, the costs of pollution and road congestion that automobile use engenders.

Increasing tax rates on motor fuels raises some issues of fairness, however. Higher rates would impose an added burden on the trucking industry and a disproportionate cost on rural households; yet the costs associated with vehicle emissions and congestion are greatest in densely populated areas, primarily the Northeast and coastal California. In addition, some researchers argue that taxes on gasoline and other petroleum products are regressive —that is, they take up a greater percentage of the income of lower-income families than of middle- and upper-income families. Other researchers find that the effects are proportionate.

RELATED OPTIONS: 270-07; Revenue Options 25 and 39

RELATED CBO PUBLICATIONS: *Reducing Gasoline Consumption: Three Policy Options*, November 2002; and *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990

Revenue Option 36

Impose a Tax on Sulfur Dioxide Emissions

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.4	0.6	0.6	0.5	0.5	2.6	4.8

Source: Joint Committee on Taxation.

Under the Clean Air Act, the Environmental Protection Agency (EPA) sets national standards for ambient air quality that are designed to protect the public's health and welfare. EPA defines acceptable levels for six "criteria" air pollutants: sulfur dioxide (SO_2), nitrogen oxides (NO_x), ozone, particulate matter, carbon monoxide (CO), and lead. Along with emissions from natural sources, emissions of air pollutants from stationary sources (such as industrial facilities and commercial operations) and mobile sources (automobiles, trains, and airplanes) contribute to the ambient levels of those criteria pollutants.

Sulfur dioxide belongs to the family of sulfur oxide gases formed during the burning of fuel that contains sulfur (mainly coal and oil) and during metal smelting and other industrial processes. Exposure to high concentrations of SO_2 may promote respiratory illnesses or aggravate cardiovascular disease. In addition, SO_2 and NO_x emissions are considered the main cause of acid rain, which the EPA believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings.

The Clean Air Act Amendments of 1990 adopted a program to control acid rain that introduced a market-based system of emission allowances to reduce SO_2 emissions. An emission allowance is a limited authorization to emit a ton of SO_2. EPA allots tradable allowances to affected electric utilities on the basis of the utilities' past fuel use and statutory limits on emissions. Once the allowances are allotted, the act requires that annual SO_2 emissions not exceed the number of allowances held by each utility plant. Firms may trade allowances, bank them for future use, or purchase them through periodic auctions held by EPA. Firms with relatively low costs for abating pollution have an economic incentive to reduce their emissions and sell surplus allowances to firms that have relatively high abatement costs.

This option would tax emissions of SO_2 from stationary sources that are not already covered under the acid rain program. The rate of the tax would be based on the average cost of an additional reduction in SO_2 emissions by those sources. That approach would result in a tax of $200 per ton of SO_2 and would raise about $2.6 billion in revenues over the 2004-2008 period. Thus, the tax would both encourage further reductions in pollution and provide significant revenues. Major sources of pollutants currently pay user fees to cover the costs of a program providing operating permits (stating which air pollutants a source is allowed to emit) under the 1990 amendments to the Clean Air Act. Basing the tax described in this option on the terms granted in the permits would minimize the Internal Revenue Service's costs of administration.

In general, taxes on emissions can help reduce pollution in a cost-effective (least-cost) manner. The tax described in this option would lead to cost-effective reductions in SO_2 emissions by encouraging firms with abatement costs that are less than the tax to reduce their emissions and, at the same time, allowing firms with abatement costs that exceed the tax to continue emitting pollutants and pay the levy.

Opponents of this kind of tax, however, might argue that it would impose a large burden on affected firms. Firms covered under this option would not only pay a tax on their emissions of SO_2 but in most cases would also incur some costs for abatement (such as the cost of scrubbers and other equipment to reduce emitted pollutants). In contrast, regulatory approaches that mandated reductions in emissions would not require firms to pay that kind of levy on their allowed emissions.

RELATED OPTIONS: Revenue Options 37 and 39

RELATED CBO PUBLICATIONS: *An Evaluation of Cap-and-Trade Programs for Reducing U.S. Carbon Emissions*, June 2001; and *Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program*, June 1998

Revenue Option 37

Impose a Tax on Nitrogen Oxide Emissions

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	3.3	4.7	4.5	4.3	4.2	21.0	40.7

Source: Joint Committee on Taxation.

Nitrogen oxides (NO_x) usually enter the air as the result of high-temperature combustion processes such as those found in automobiles and power plants. Emissions of NO_x play an important role in the atmospheric reactions that generate ground-level ozone (smog) and acid rain. Moreover, the Environmental Protection Agency (EPA) believes that NO_x can irritate the lungs and lower a person's resistance to respiratory infections such as influenza. Nitrogen oxides and pollutants formed from them can be transported over long distances, so problems associated with NO_x are not confined to areas where they are emitted.

The Clean Air Act requires states to implement programs to reduce ground-level ozone. Because of the transportability of NO_x and ozone, the act requires upwind states to establish programs that will help downwind states meet statutory standards. In 1998, EPA promulgated the Ozone Transport Rule (commonly referred to as the NO_x Sip call), which required 22 eastern states and the District of Columbia to revise their programs to reduce NO_x emissions beyond the levels previously mandated under the Clean Air Act. (The rule was subsequently revised to cover all or part of 21 states.) The rule did not mandate specific methods but instead gave each affected state a target for NO_x emissions. In addition, EPA established a NO_x budget trading program in which large electricity-generating units and industrial boilers may participate—provided that the state in which they are located approves. Sources of emissions covered under that program would be issued a specific number of allowances that would entitle them to emit a limited amount of NO_x each year. Firms would be required to hold an allowance for each ton of NO_x that they emitted and would be free to buy and sell allowances.

Another way to help control NO_x would be to tax emissions from stationary sources in states not covered by the NO_x Sip call. Such a tax would apply to industrial facilities and commercial operations, including electricity-generating units and industrial boilers as well as other sources; it could provide significant revenues and encourage further reductions in pollution below the level that current regulations require. Controlling NO_x from stationary sources costs between $500 and $10,000 per ton of emissions abated. Imposing a tax of $1,500 per ton of NO_x emissions would encourage stationary sources that could reduce emissions at a cost below that amount to do so. Facilities with abatement costs that were higher than the tax could continue to pollute and pay the levy. A tax of $1,500 per ton would raise over $3.3 billion in revenues in 2004 and $21.0 billion over the 2004-2008 period.

Proponents of taxing pollution argue that such taxes discourage activities that impose costs on society and could help reduce air pollution in a cost-effective (least-cost) manner. Opponents of that kind of tax, however, might argue that it would impose a large burden on affected firms. Firms covered under this option would not only pay a tax on their emissions of NO_x but in most cases would also incur some costs for abatement (such as the cost of scrubbers and other equipment to reduce emitted pollutants). In contrast, regulatory approaches that simply mandated reductions in emissions would not require firms to pay a tax on the emissions.

RELATED OPTIONS: Revenue Options 36 and 39

RELATED CBO PUBLICATION: *Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program*, June 1998

Revenue Option 38

Subject Vehicles with a Gross Vehicle Weight of Between 6,000 and 10,000 Pounds to the Gas Guzzler Tax

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.5	0.6	0.6	0.6	0.6	2.9	6.1

Source: Joint Committee on Taxation.

Under the Energy Tax Act of 1978, most automobiles whose fuel economy fails to meet a certain level are subject to the gas guzzler tax. For example, the manufacturer of an automobile belonging to a "model type" whose adjusted miles per gallon (mpg) rate is under 22.5 pays a tax for each of those vehicles that it sells. (The adjusted mpg rate is a combined fuel economy measure that is calculated by assuming 55 percent city and 45 percent highway driving.) The lower the gas mileage of the model type, the higher the tax that is paid. The maximum tax is $7,700 per vehicle with gas mileage of less than 12.5 mpg.

In fact, few vehicles are subject to the gas guzzler tax. Currently, the tax does not apply to vehicles that are rated at more than 6,000 pounds unloaded gross vehicle weight (GVW). In practice, it also does not apply to minivans, trucks, or sport utility vehicles (SUVs), a group collectively known as light trucks. One reason for that group's exclusion is that the tax code exempts "non-passenger vehicles"—as defined by the Department of Transportation (DOT)—from the tax. DOT's definition includes pickup trucks; vans; and most minivans, SUVs, and station wagons. Another reason is that the tax is imposed on the basis of the gas mileage of the model type to which the vehicle belongs. Model types are defined by the Environmental Protection Agency; each category comprises different vehicles that have one or more construction features in common. Hence, a vehicle with gas mileage of 15 mpg may not be subject to the gas guzzler tax because it is a member of a model-type category that has an average fuel economy of more than 22.5 mpg.

This option would extend the gas guzzler tax to light trucks by increasing the tax's weight limit to 10,000 pounds unloaded GVW, repealing the exemption for so-called nonpassenger vehicles, and calculating the tax per vehicle instead of on the basis of model type. The option would increase revenues by about $0.5 billion in 2004 and $2.9 billion over the 2004-2008 period.

Proponents of this option could argue that not applying the gas guzzler tax to light trucks creates an incentive for people to buy those large vehicles instead of smaller, more energy-efficient ones. (In 1978, light trucks made up about 27 percent of retail sales of motor vehicles; in 2000, their share of the market was 50 percent.) Vehicles with low gas mileage generate more pollution than do vehicles with higher mileage, so taxing less-efficient vehicles could reduce pollution. The tax was intended to encourage the manufacture and sale of energy-efficient vehicles and the reduction of pollution, but it has been less effective than it might have been (because certain vehicles have been exempt).

Opponents of the option might point out that many light trucks are used for purely commercial purposes and that this option would impose a burden on businesses that had economic reasons for purchasing larger vehicles. Opponents would also maintain that many light trucks carry more passengers than automobiles do, so pollution per passenger mile may be lower for those vehicles than for automobiles. Some observers would also argue that the gas guzzler tax should not be extended and that, in fact, the tax on passenger cars should be repealed and replaced with either a tax on the pollution that cars and light trucks emit or a tax placed directly on energy use (such as a gasoline tax). Those critics would say that such taxes would be more efficient than the current gas guzzler tax or a gas guzzler tax extended to light trucks.

Revenue Option 39

Impose a One-Time Tax on Emissions of New Automobiles and Light Trucks

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	2.5	3.7	3.8	3.8	3.8	17.6	37.4

Source: Joint Committee on Taxation.

The Clean Air Act Amendments of 1990 strengthened the provisions of the earlier law that sought to reduce emissions from mobile sources of pollution. The amendments raised the tailpipe standards for cars, buses, and trucks; they expanded inspection and maintenance programs to include more regions with pollution problems and promote more stringent testing; and they introduced several regulations to reduce air pollution from mobile sources, including regulations for selling improved gasoline formulations in some polluted cities to reduce levels of pollutants. In addition, the amendments tightened emission standards for vehicles to encourage the development of even cleaner cars and fuels.

Despite progress to date in controlling air pollution from motor vehicles, mobile sources continue to significantly affect the nation's air quality. Nationwide, highway motor vehicles on average account for over one-quarter of all emissions of volatile organic compounds (VOCs), over one-third of nitrogen oxide (NO_x) emissions, and more than half of carbon monoxide emissions. VOCs and NO_x contribute to atmospheric reactions that generate ground-level ozone, which remains a pervasive pollution problem for many areas of the United States. Nitrogen oxides also contribute to the formation of acid rain, which the Environmental Protection Agency (EPA) believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings. Carbon monoxide reduces the ability of a person's blood to deliver oxygen to vital tissues, affecting primarily the cardiovascular and nervous systems.

Taxing emissions of those pollutants from mobile sources could help reduce them by providing an additional incentive for consumers to purchase more-fuel-efficient cars and trucks. One option would be to impose a one-time tax on new automobiles and light trucks. The tax could be based on the grams of VOCs (measured in grams of hydrocarbons), NO_x, and carbon monoxide that a vehicle emitted per mile as estimated by the emissions tests that EPA requires for every new vehicle. The tax could be administered similarly to the current excise tax on luxury vehicles: the auto dealer would collect the tax from the vehicle's purchaser on behalf of the Internal Revenue Service.

Such a tax, which would average $300 for each new passenger car and light truck sold, could raise about $2.5 billion in revenues in 2004 and a total of $17.6 billion from 2004 through 2008. A disadvantage of the option, however, is that it would leave out older cars and trucks, which account for a larger share of emissions from mobile sources than do new vehicles. A further drawback is that a one-time emissions tax would raise the prices of new vehicles and might therefore induce people to delay purchasing them.

RELATED OPTIONS: Revenue Options 35, 36, and 37

Revenue Option 40

Eliminate Tax Credits for Producing Unconventional Fuels and for Generating Electricity from Renewable Energy Sources

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.4	0.7	0.7	0.8	0.4	3.0	3.9

Source: Joint Committee on Taxation.

Under current law, firms that produce unconventional fuels or generate electricity from certain renewable forms of energy can claim a credit against their income taxes. Section 29 of the Internal Revenue Code offers credits to businesses that produce natural gas from coal seams (known as coalbed methane), oil from shale and tar sands, gas from geopressured brine and Devonian shale, energy from biomass (including landfill methane), and synthetic fuels from coal. Section 45 of the code offers credits to producers of electricity from wind, closed-loop biomass (including landfill methane), and poultry waste.

The tax credits may prompt some businesses to reduce the price of energy from those sources or may lead to larger profits for manufacturers. Lower prices—or larger profits—in turn may lead to greater reliance on unconventional forms of energy. But that outcome has seldom been achieved. Only coalbed methane, landfill methane, and wind power have been commercially viable sources of energy. Eliminating the credits would increase revenues by $0.4 billion in 2004 and $3.0 billion over the 2004-2008 period.

The credits were initially enacted to promote energy security and efficiency (by encouraging consumers to use alternatives to imported petroleum as well as energy that would otherwise be lost) and to foster a cleaner environment (by encouraging the use of nonpolluting sources of energy). But proponents of eliminating the credits point out that the energy sources that benefit from them contribute very little to meeting the nation's energy requirements. Moreover, the limited success that markets for coalbed methane, landfill methane, and wind power have had is attributable less to the credits than to such factors as technological advances, rising natural gas prices, other federal programs (such as the Environmental Protection Agency's New Source Performance Standards), and subsidies from the states. Indeed, critics claim that far from benefiting the environment, the production of energy from some of the eligible sources causes environmental problems. (For example, wind rotors may endanger migratory birds, and coalbed methane production may harm groundwater.) In addition, the credits may reduce economic efficiency by encouraging the use of relatively expensive fuels. Finally, proponents of eliminating the credits believe that the goal of promoting a cleaner environment would be more efficiently achieved by imposing taxes on pollutants that reflect the damage they cause.

Advocates of retaining the tax credits argue that they remain an important part of the national policy to promote development of new sources of energy. Moreover, they believe that the credits help curb wasteful and polluting practices. For example, capturing landfill methane as a fuel rather than venting it into the air reduces odors and other hazards associated with emissions of landfill gas. And encouraging the use of poultry waste as fuel may help reduce the negative consequences—such as water pollution and unpleasant odors—of traditional means of its disposal. To the extent that the tax credits encourage the use of renewable sources of energy, they may also help moderate human impacts on the global climate.

RELATED OPTIONS: 270-01, 270-03, and 270-07

Revenue Option 41

Reinstate the Superfund Taxes

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues	0.9	1.3	1.4	1.5	1.6	6.7	15.3

Source: Joint Committee on Taxation.

Since 1981, the Superfund program of the Environmental Protection Agency (EPA) has been charged with cleaning up the nation's most hazardous waste sites. Most Superfund cleanups are paid for by the parties that are held liable for contamination of individual sites. In many cases, however, the liable parties cannot be identified, no longer exist, or are unwilling or unable to undertake the job. In such cases, EPA pays for the cleanup and, where possible, tries to recover the costs through subsequent enforcement actions.

Money to pay for those EPA-led cleanups and other program costs comes from an annual appropriation. Traditionally, the Congress has designated two sources of funds in the appropriation: the general fund and balances in the Superfund trust fund (formally, the Hazardous Substance Superfund). Revenues credited to the trust fund have come primarily from taxes on petroleum and various industrial chemicals and from a corporate environmental income tax. However, authorization for the taxes expired in December 1995, and the fund's balance has declined every year since 1997.

The Congress has slowed the decline by relying more on the general fund as a source of the program's appropriated money. (Before 1999, the maximum contribution from the general fund was $250 million; in 2000, it was $700 million; in 2001, $634 million; and in 2002, $635 million.) Still, the available balance in the trust fund at the end of 2002 was expected to be just $427 million, or about one-third of the program's 2002 appropriation of $1.3 billion. Thus, future funding for the Superfund program will come almost entirely from the general fund unless the trust fund gets a new or renewed source of revenues. One option would be to reinstate the previous taxes; doing so would yield revenues of $0.9 billion in 2004 and $6.7 billion over the 2004-2008 period.

Proponents of reauthorizing the taxes argue that they are consistent with the "polluter-pays" principle. Specifically, proponents maintain that petroleum products and various chemical feedstocks and derivatives are common sources of contamination at Superfund sites and thus it is fair that producers and users of such substances, as well as corporations more broadly, foot much of the bill for the cleanup program. Some advocates of renewed taxation also argue that EPA needs a stable source of funding for Superfund, for two reasons: to maintain multiyear cleanup efforts at the largest sites and to continue to provide a credible threat that the agency will clean up sites and pursue cost recovery from liable parties who do not undertake cleanups themselves.

Some people who oppose reinstating the taxes argue that the Superfund program should not be given dedicated funding until the Congress reforms the program's liability system and clarifies its future mission. Other opponents criticize the taxes themselves. They point to a 1995 analysis by the Brookings Institution and Resources for the Future, which found that the costs to administer and comply with the taxes were high, compared with the relatively small amounts collected. Also, they argue that the polluter-pays principle may be relevant to Superfund's liability system but has no bearing on the question of who should pay for the cleanup of sites whose liable parties are recalcitrant or insolvent. Finally, opponents of reinstating the taxes argue that Superfund spending has always been subject to annual appropriations and thus dedicated taxes are no guarantee of stable funding.

Revenue Option 42

Consolidate Child-Related Tax Provisions

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Revenues	-0.4	-2.4	-6.6	-11.2	-15.1	-35.7	-151.9

Source: Joint Committee on Taxation.

The tax code currently contains several provisions—specifically, the child credit and the exemption for dependents—that benefit taxpayers with children. However, those provisions have different structures and rules for eligibility. The child credit equals $600 per child in 2003 and is refundable; the refundable portion—the amount that exceeds tax liability and is paid to the taxpayer—is limited to an amount equal to 10 percent of earnings above $10,500. The credit phases out by $50 for every $1,000 of adjusted gross income over certain thresholds: $110,000 for married couples filing jointly, $75,000 for single taxpayers and heads of household, and $55,000 for married couples filing separately. Under the dependent exemption, a taxpayer may exclude (deduct) $3,050 from his or her taxable income for each child. The value of the exemption rises with the taxpayer's marginal tax rate (the rate on the last dollar of income), so upper-income families receive greater tax savings from the deductions than their lower-income counterparts do.

This option would replace the two provisions with a single consolidated credit of $1,000 per child beginning in 2004. The consolidated child credit would retain a refundable portion, which would be determined in the same way as the refundable part of the current child credit. However, unlike the current credit, there would be no phaseout, and the amount of the credit would be indexed for inflation. For the purposes of the credit, a child would be defined as either a son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or descendant of such individuals; as an adopted child; or as a foster child. The child would have to be under age 19 (or age 24, if he or she was a student) and live for more than half the tax year with the taxpayer (or taxpayers) claiming the credit. (Students would be exempted from the residence requirement.)

The specific elements of this option are illustrative and could be modified to alter its effect. As described, the option would reduce federal revenues by $0.4 billion in 2004 and $35.7 billion over the 2004-2008 period.

Proponents of this option might point out that consolidating the provisions into a single credit would substantially reduce complexity in this area of the tax code, as would the elimination of any phaseout. Opponents, however, might express concern that some middle-income taxpayers with children would see their taxes rise. They might also argue that the dependent exemption has been part of the tax code for a long time and many taxpayers may count on the money it represents when they make their financial plans.

RELATED OPTION: Revenue Option 1

Revenue Option 43

Replace Multiple Tax Rates on Long-Term Capital Gains with a Deduction of 45 Percent

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Revenues	2.6	-4.4	-0.8	0.2	0.2	-2.2	0

Source: Joint Committee on Taxation.

When a taxpayer sells an asset whose value has increased since it was purchased, he or she realizes a capital gain, which is subject to taxation. The gains realized on assets that are held for more than a year are taxed at lower rates than the rates that apply to ordinary income. Which capital gains tax rate applies to a gain depends on the type of asset sold, how long it was held, when it was purchased, and the taxpayer's other income—a level of complexity that requires numerous calculations by taxpayers to figure their tax. To simplify that process, this option would allow taxpayers to deduct 45 percent of their net long-term capital gains realizations from their taxable income—whether or not they itemized their other deductions. Taxpayers subject to the alternative minimum tax (AMT) would treat 30 percent of the deduction as preference income to adjust for the lower rate structure of that tax. (Revenue Option 44 discusses the AMT.) Although the five-year total for the effects of this option shows a loss of revenues of $2.2 billion, the option would be approximately revenue neutral from 2004 to 2013 (under the assumption that the change would be enacted at the end of 2003 and become effective January 1, 2004).

The variety of long-term capital gains tax rates in current law presents a substantial challenge to taxpayers who attempt to calculate their tax liability. For example, in 2002, a taxpayer who was in an individual income tax bracket of 27 percent or above and who sold stock owned for more than a year would generally pay tax of 20 percent on the realized gain. But if that stock had been an original issue of certain start-up businesses and had been held for more than five years, the tax rate on the gain would be effectively 14 percent. If that stock had not been an original issue but had been purchased in 2001 or later, and if it was held for more than five years, the tax rate, as now scheduled, would be 18 percent. Furthermore, the taxpayer could face a 25 percent tax rate on some long-term gains from real estate and a 28 percent rate on gains from the sale of gold, works of art, or other collectibles. Taxpayers in the 10 percent or 15 percent brackets of the individual income tax face lower rates on gains until they realize enough to push their income past the 15 percent bracket. Taxpayers who are subject to the AMT face different rates on gains from the sale of collectibles and from original stock issues of certain start-up businesses.

Taxpayers with long-term gains are required to go through many calculations to determine their tax. On their 2002 returns, taxpayers with gains from the sale of general corporate stock, for example, have to complete 22 lines at the end of Schedule D, Form 1040. Taxpayers with gains from collectibles, start-up businesses, or depreciable real estate are sent to a 37-line worksheet.

This option would reduce the number of lines that a taxpayer faced at the end of Schedule D to two or three, as was required between 1942 and 1986, when the tax code excluded gains from adjusted gross income. The deduction under this option would be calculated like that exclusion but would not understate the income of taxpayers with gains in determining eligibility for tax credits and other options intended for lower-income taxpayers.

Under the option, a taxpayer's actual rate on capital gains would be 55 percent of his or her rate on ordinary income. In 2004, for example, someone in the 26 percent bracket for ordinary income would face a rate on gains of 14.3 percent, whereas someone in the 37.6 percent bracket would face a rate on gains of 20.7 percent.

Switching to a uniform percentage deduction for long-term capital gains, however, would overturn several provisions of the tax code that were designed to improve efficiency or equity or to promote economic growth. As a result, careful consideration is warranted in weighing the benefits of those provisions against the benefits of simplification.

A reduction of 2 percentage points in the gains tax rate on assets held more than five years was enacted partly to reduce the pressure on businesses—which has been strong in recent years—to meet quarterly earnings targets and produce short-run increases in the value of their stock in order to attract investors. Excessively focusing on short-run results can deter businesses from undertaking more-productive actions that may take several years to reach fruition. However, much current short-term trading is done by institutions, many of which are exempt from individual capital gains taxes. Furthermore, long-term investors are not a necessary component of a firm's planning for the long term. A string of investors who all hold a stock for short intervals can provide a market to maintain the value of the firm's shares if the firm's long-term plans are plausible.

When the tax rate on gains held more than five years was lowered, an argument that was offered in support of the action was that gains resulting from inflation, which should not be taxed as income, grow over time. That argument is typically false, however, because it ignores the advantage that the tax code provides of deferring taxes on gains until an asset is sold. When deferral is accounted for, the effective tax rate on capital gains is still boosted by inflation, but the amount of that increase typically declines the longer an asset is held. Thus, if the lower statutory rate for gains (relative to ordinary income) was meant solely to account for inflation, that differential should decline the longer an asset is held.

The current lower tax rate on capital gains realized from initial public offerings (IPOs) held at least five years was designed to encourage new enterprises that might develop new products and methods to benefit the entire economy. But evidence is lacking about how big those benefits actually are; moreover, the costs from excess business formation—such as increased business failures—must be considered as well. Another question involves the size of the differential tax rate. When the differential was created in 1993, it reduced the rate on gains from IPOs to half of the rate paid on other gains. But when the rates on other gains were reduced in 1997, that differential was eroded. Now, the top rate of 14 percent on gains from IPOs may not be enough lower than the 20 percent and 18 percent rates on most other gains to justify the extra complexity that special IPO rates create.

Gains on gold, works of art, and other collectibles are currently taxed at a higher rate (28 percent) than are gains on most other assets. Supporters of maintaining those higher rates justify their position by the lack of broader benefits—in terms of innovation, new products, and higher productivity—that society receives from those assets. But other observers argue that public benefits arise from the preservation of works of art. In any event, so few gains fall into this category that the economic efficiency resulting from having just the right tax rate for these assets may be less than the administrative costs of maintaining a separate rate.

Certain gains from the sale of real estate are taxed at ordinary income tax rates up to a maximum of 25 percent (which is above the 20 percent rate levied on gains from most other assets). The higher rate could be justified on the grounds that such gains arise when tax deductions for depreciation turn out to have been excessive, a circumstance that becomes evident when the structures are sold for more than their depreciated tax value. During the time that such property is being used to generate profits and rent—which are taxed at ordinary income tax rates—the owners are taking deductions for the depreciation of the property's value that reduce their (ordinary income) taxes. Logic suggests that gains resulting from excess depreciation deductions also be taxed at those rates; that rationale is followed in taxing—at ordinary income tax rates—the gains from all excess depreciation on sales of equipment and the portion of excess depreciation on real estate that results when depreciation for tax purposes is faster (because in some instances the tax code permits accelerated depreciation) than the conventional straight-line method. However, the remaining fraction of the gains that owners derive from excess depreciation deductions on real estate is taxed at rates that are capped at 25 percent. This option would treat all excess depreciation deductions—including that fraction—as ordinary income (and tax them at ordinary rates) on the basis of the above rationale and the goal of administrative simplicity. Arguments against taxing those gains at a higher rate than the rate imposed on some other gains could be based on the additional costs of administering a multirate system and the burden imposed on investors who have been taxed at gains rates since 1942.

Current tax law also includes different capital gains tax rates for people with different levels of total income. Those rates reflect part of the progressive rate structure on ordinary income, but as separate rates, they add to the complexity of calculating overall tax liability. Under the option presented here, the progressive rates applicable to ordinary income would apply to capital gains as well.

The benefits to be derived from multiple tax rates for capital gains may not be large, but the benefits resulting from simpler tax calculations may be no larger. The tax code's current complexity affects only the roughly one out of six taxpayers who report capital gains. Furthermore, roughly three-fourths of those with gains can avoid the most extended worksheets. Other taxpayers with substantial capital gains typically use professional tax-return preparers or computer software, both of which mitigate the burden of filling out the current forms—although they impose added costs for filing. Finally, some of the current complexity could be eliminated by simply taxing all gains at the same rate, without turning to a deduction.

RELATED OPTION: Revenue Option 3

RELATED CBO PUBLICATIONS: *Capital Gains Taxes and Federal Revenues*, October 2002; and *Indexing Capital Gains*, August 1990

Revenue Option 44

Provide Relief from the Individual Alternative Minimum Tax

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Revenues							
Index exemption amounts and brackets for inflation after 2004	0	-4.0	-13.6	-22.0	-31.5	-71.1	-288.8
Allow some preferences	-5.0	-17.6	-33.3	-49.9	-65.0	-170.8	-533.8
Repeal the AMT	-7.4	-23.4	-39.5	-57.3	-73.5	-201.1	-611.1

Source: Joint Committee on Taxation.

Under current law, the individual alternative minimum tax (AMT), as its name implies, is an alternate method of computing federal income tax liability. A minimum tax was initially enacted in 1969 amid concerns that taxpayers with substantial income were able to aggressively use tax preferences to reduce their tax liability to very low levels—in some cases, to zero. The present form of the AMT was largely enacted as part of the Tax Reform Act of 1986; it has since been modified several times, most recently by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

To compute AMT liability, a taxpayer must add back several items to taxable income that are not regularly included in it, such as the deduction for state and local taxes, personal exemptions, and the standard deduction. AMT adjustments also include preferences that are generally used only by taxpayers with complex financial circumstances—such as the preferences for certain intangible costs of drilling for oil and gas. Those adjustments are replaced with an AMT exemption—$33,750 for single taxpayers and $45,000 for married taxpayers filing a joint return— that phases out at higher levels of income. The exemption is subtracted from income, yielding a taxpayer's alternative minimum taxable income (AMTI). AMTI is taxed at two rates: 26 percent on the first $175,000 and 28 percent on the remainder. Taxpayers must pay the higher of their AMT liability or their liability under the individual income tax. Additionally, they may not take certain tax credits if the credit would make their individual income tax liability lower than their AMT liability.

Unlike the schedule of brackets and exemptions for the individual income tax, the AMT brackets and exemptions are not indexed for inflation. As a result, growth in nominal income subjects more and more taxpayers to the alternative tax. For a given level of nominal income, individual income tax liability will decline over time as the value of personal exemptions and the standard deduction increases with inflation; in addition, the size of the lower tax brackets increases, so more income is taxed at lower rates. However, because AMT liability remains unchanged by inflation, with time it will exceed individual income tax liability over a larger and larger portion of the income range.

Before passage of EGTRRA, the number of taxpayers subject to the AMT was projected to grow rapidly from 1.5 million in 2001 to 16 million in 2010. But EGTRRA lowered individual income tax rates with little change in the AMT and so increased to 32 million the projected number of taxpayers who will be subject to it in 2010. The law provided some relief from the AMT by increasing the size of its exemption but only through 2004.

Taxpayers who are subject to the AMT, or are close to being affected by it, have to calculate their taxes twice. As the number of those taxpayers rises sharply, the overall complexity of the tax system will increase. Many of those taxpayers will be in the AMT's ranks not because they are sheltering high income but rather because they have large numbers of dependents or high state and local taxes.

The AMT could be modified in several ways to provide some relief from its burdens. One option would be to make permanent the relief provided by EGTRRA and index the exemption amounts and brackets for inflation after 2004. Under that option, 21 million taxpayers would be moved off the AMT in 2010 (the peak year), and revenues for the 2004-2008 period would fall by $71 billion. Another option would be to allow AMT-affected taxpayers to take the standard deduction, personal exemptions, and the deduction for state and local taxes—which would reduce the tax's rolls by 29 million in 2010 and lower revenues by $171 billion over the five-year period. A third option would be to eliminate the AMT altogether. That approach would move 32 million taxpayers off the tax in 2010 at a revenue cost of $201 billion over five years.

The primary benefit of these alternatives would be simplification—each one would simplify the tax system by reducing the number of taxpayers subject to the AMT. The first two options would provide relief to taxpayers with simple returns but maintain the goal of preventing high-income taxpayers from using tax shelters to avoid income taxes. The third option would reduce complexity the most. Proponents of AMT relief would also argue that many preferences that are not allowed by the AMT, such as personal exemptions and state and local taxes, represent differences in taxpayers' ability to pay taxes and consequently, equity calls for allowing those items to be subtracted from taxable income.

Opponents of these options might argue against them on several counts. Because the options would reduce taxes, they would be costly, and the cost would rise as the amount of AMT relief increased. Equity could be at issue as well, given that higher-income taxpayers would receive most of the options' tax relief. Approaches other than complete elimination of the AMT would leave in place some of the complexity of the current system; however, complete elimination would also result in cases in which high-income taxpayers had little or no tax liability.

A further consideration is that relief from the AMT would change the marginal tax rate (the tax rate on the last dollar of income) faced by taxpayers who are currently subject to the tax and might thus alter their incentives to work and save. Some taxpayers would see their marginal rates increase under these options, and others would see them decrease; on balance, though, more taxpayers would see marginal rate decreases. AMT relief might further affect incentives to work by reducing some taxpayers' tax burdens—lower tax liability would allow those individuals to achieve the same level of after-tax income with less income before taxes. How AMT relief on balance would affect incentives to work and save is not clear; it would depend on taxpayers' relative sensitivity to those incentives.

Revenue Option 45

Immediately Eliminate the Personal Exemption Phaseout and the Limit on Itemized Deductions

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Revenues	-5.5	-10.8	-8.1	-5.6	-4.3	-34.3	-90.8

Source: Joint Committee on Taxation.

Under current law, taxpayers subtract personal exemptions and either the standard deduction or itemized deductions from their adjusted gross income (AGI) to compute their taxable income. The value of both personal exemptions and itemized deductions is reduced for high-income taxpayers by gradually phasing them out above specified income thresholds. The provisions for the two phaseouts were enacted temporarily as part of the Omnibus Budget Reconciliation Act of 1990 and made permanent by the Omnibus Budget Reconciliation Act of 1993. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), both provisions are scheduled to phase out gradually over the next several years. In 2006 and 2007, their impact will be reduced by one-third; in 2008 and 2009, it will be reduced by two-thirds; and in 2010, the provisions will be repealed. Since EGTRRA remains in effect only until the end of 2010, the phaseouts will return, in their pre-EGTRRA form, in 2011.

This option would accelerate to 2004 the planned repeal of the phaseouts and make the repeal permanent. Immediate repeal would cost $5.5 billion in revenues in 2004 and $34.3 billion over the 2004-2008 period.

The personal exemption phaseout, often referred to as "PEP," reduces the value of personal exemptions by 2 percent for each $2,500 of AGI above an income threshold. In 2002, that threshold was $137,300 for single filers and $206,000 for married couples filing a joint return. Thus, single taxpayers with AGI of $162,300 ($25,000 above the threshold) would lose 20 percent of the value of their personal exemption. In 2002, the value of personal exemptions was completely phased out for single filers with AGI above $259,800 and joint filers with AGI above $328,500.

The limit on itemized deductions, often referred to as "Pease," reduces them by 3 percent of the amount of AGI above an income threshold—which was $137,300 for all taxpayers in 2002. Thus, a taxpayer with $237,300 in AGI would have his or her itemized deductions reduced by $3,000, or 3 percent of the $100,000 in AGI above the threshold. Under current law, itemized deductions cannot be reduced by more than 80 percent.

Repealing Pease and PEP would make the tax system less complex. Both provisions require numerous calculations by taxpayers to determine whether the provision applies to them and, if it does, to figure the impact of the phaseouts on their taxable income. Proponents of this option would argue that repeal would increase economic efficiency by lowering marginal tax rates (the tax rate applied to the last dollar of income). Currently, both provisions increase marginal tax rates over the portion of the income range that they affect and may thus reduce incentives to work and save.

Opponents of this option might object to it largely on equity grounds. Because the tax system is progressive (rates rise with a taxpayer's income), higher-income taxpayers get a bigger tax reduction from exemptions and deductions than do taxpayers in lower tax brackets. The Pease and PEP provisions reverse that effect and increase the tax system's progressivity.

Revenue Option 46

Advance the Marriage Penalty Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

						Total	
(Billions of dollars)	2004	2005	2006	2007	2008	2004-2008	2004-2013
Revenues	-16.7	-17.3	-9.7	-6.9	-3.2	-53.8	-227.1

Source: Joint Committee on Taxation.

Many married couples who file a joint return have higher tax liabilities than they would if they were allowed to file as individuals or as heads of household (single taxpayers with dependents). At the same time, many other married couples pay lower taxes than they would if they filed as single taxpayers. Whether a couple incurs a marriage "penalty" or receives a marriage "bonus" depends on the spouses' relative income: penalties generally occur when spouses have similar income, and bonuses occur when only one spouse works or when spouses have substantially different earnings. Penalties tend to be larger for couples with dependents who would qualify them to file as heads of household if they were not married.

In 1999, just over 40 percent of married couples incurred marriage penalties averaging $1,480, and about 50 percent received marriage bonuses averaging $1,600. Overall, bonuses totaled $43 billion, or about $10 billion more than total penalties. High-income couples were more likely to incur penalties and less likely to receive bonuses than were couples with lower income. About 70 percent of both penalties and bonuses affected couples with income above $50,000.

Four provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were designed to lessen the effects of the marriage penalty. Only one of those measures was fully implemented in 2001; the others phase in over varying periods and at different times from 2002 through 2009. All of the measures expire on December 31, 2010, leaving in place the same tax structure for married and unmarried taxpayers that existed before 2001. This option would fully implement those four provisions, effective in 2004, and make them permanent, at a cost of $16.7 billion for 2004 and $53.8 billion for the 2004-2008 period. A summary of the provisions follows.

- EGTRRA established an individual income tax bracket of 10 percent, effective from July 31, 2001, through December 31, 2010. For a married couple filing a joint return, that bracket is twice the size of the corresponding bracket for unmarried individuals filing a single return. The bracket's upper dollar limits are fixed through 2007; they increase for single and joint filers by $1,000 and $2,000, respectively, in 2008 and are indexed to inflation for all taxpayers in 2009 and 2010.

- From 2005 through 2009, the law gradually increases the standard deduction for married couples filing jointly from approximately 166 percent to 200 percent of the deduction for single taxpayers. Under that implementation schedule, the standard deduction for married couples filing jointly would be twice that for single filers in 2009 and 2010.

- Between 2005 and 2009, EGTRRA widens the 15 percent individual income tax bracket for married couples filing jointly to twice that for a single filer. The current upper dollar limit on that bracket for joint filers is about 166 percent of that for single taxpayers.

- Finally, for married couples filing jointly, EGTRRA increased by $1,000 the beginning and ending phaseout limits for income on which the earned income tax credit (EITC) applies in each of tax years 2002, 2005, and 2008. After 2008, those limits are indexed for inflation. Before EGTRRA, the phaseout limits for single and joint filers were identical.

Many analysts have observed that marriage penalties affect couples' decisions about whether to marry and how much to work. Reducing marriage penalties would lessen the tax code's disincentives to marry and, if the changes in EGTRRA were made permanent, simplify families' financial planning. In addition, because this option would lower the marginal tax rate (the rate that applies to a taxpayer's last dollar of income) for many couples, it would help reduce the adverse impact of taxes on labor supply. Research has shown that how much the secondary earners in couples work—that is, the spouses with the lower of the two incomes—is particularly sensitive to tax rates. (An analysis published by the Congressional Budget Office in 1997, using simulations and the pre-EGTRRA tax code, indicated that higher tax rates for lower-earning spouses could prompt them to work from 4 percent to 7 percent less than they might have if they could have filed individually.)

Opponents of the option would argue that it would not only reduce marriage penalties but also increase marriage bonuses. The latter outcome would effectively penalize unmarried taxpayers relative to their married counterparts.

Revenue Option 47 (Revised March 12, 2003)

Freeze Tax Rates and Brackets at the 2002 or 2004 Level Under EGTRRA, and Index the Brackets' Upper Limits for Inflation

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues							
Freeze rates and brackets at 2002 level and index for inflation	10.8	13.3	24.4	29.0	30.0	107.5	-0.5
Freeze rates and brackets at 2004 level and index for inflation	-0.5	-1.4	10.9	15.9	17.6	42.5	-143.0

Source: Joint Committee on Taxation.

Before 2001, the federal individual income tax contained five brackets, under which income was taxed at 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a 10 percent bracket beginning in 2001; other provisions lower the top four tax rates in stages, beginning in 2006 and later, to 25 percent, 28 percent, 33 percent, and 35 percent. (The 15 percent rate was not changed.) All but the lowest bracket are indexed for inflation throughout the 2004-2013 period, and indexing of the 10 percent bracket will begin in 2009. As with all provisions of EGTRRA, the tax rates revert to their pre-2001 levels after the law expires on December 31, 2010.

This option would freeze the tax-bracket changes established by EGTRRA at either their 2002 or 2004 levels. For 2002, the brackets include the new 10 percent bracket and rates for the higher levels—27 percent, 30 percent, 35 percent, and 38.6 percent—that are each 1 percentage point lower than the rates in effect before 2001. The rates for 2004 are the same except that the top four rates are each reduced by an additional percentage point. Both alternatives would index all brackets for inflation beginning in 2004.

Freezing the brackets at their 2002 levels would increase revenues by $10.8 billion in 2004 and $107.5 billion over the 2004-2008 period. Moving permanently to the 2004 brackets would decrease revenues by $0.5 billion in 2004 and $143 billion over the 2004-2008 period.

Proponents of freezing EGTRRA's cuts in tax rates assert that the slowdown in the economy and the accompanying drop in revenues make it desirable for higher-income taxpayers to forgo the law's scheduled rate reductions in the interest of balancing the budget. All taxpayers saw their rates fall in 2001, and these options would maintain those cuts. However, they would also deny additional cuts on the grounds that future rate reductions under EGTRRA would affect only the top four brackets, which apply to the 32 percent of taxpayers with the highest income. Making the rate cuts permanent, say proponents of the option, would also simplify planning for the future. The scheduled expiration of EGTRRA's provisions after 2010 creates uncertainty about whether the Congress will change the law over the next few years. Some of that uncertainty could be mitigated by freezing tax brackets at specified levels.

Opponents of freezing tax rates above the levels scheduled for 2006 argue that lower tax rates will generate more-rapid economic growth as taxpayers decide to work and invest more. High marginal tax rates (the rate that applies to a taxpayer's last dollar of income) discourage work and investment and thus constrain both the level of economic activity and the revenues collected on that activity. Lower tax rates, goes this argument, will encourage economic growth, which can help provide for future needs.

Revenue Option 48 (Revised March 12, 2003)

Extend or Freeze the Estate and Gift Tax Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

(Billions of dollars)	2004	2005	2006	2007	2008	Total 2004-2008	Total 2004-2013
Added Revenues							
Option 1	0	0	0	4.8	5.8	10.6	10.0
Option 2	0	-7.2	-7.6	-4.0	-3.9	-22.7	-77.1
Option 3	-5.5	-31.2	-34.6	-31.6	-34.1	-137.0	-360.8
Option 4	-0.5	-0.8	-1.0	-1.3	-1.7	-5.3	-161.7

Source: Joint Committee on Taxation.

When a person dies, an estate tax is imposed on the value of assets that are transferred at death, and a gift tax is paid on the value of taxable gifts made during the decedent's lifetime. Only the amount of the estate that exceeds an exemption amount ($1 million in 2003 and increasing thereafter until 2011) is subject to the estate tax. Likewise, only taxable gifts that exceed the lifetime exemption amount ($1 million in 2002 and thereafter) are subject to the gift tax. Gifts and bequests between spouses and charitable bequests are exempt from taxation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phases out and ultimately repeals estate taxes. (It does the same for generation-skipping transfer taxes, which are designed to prevent estates from escaping some estate taxation by the transferring of assets —through gifts during life or through bequests—to individuals more than one generation younger than the transferer.) In addition, EGTRRA retains but reduces the gift tax.

The phaseout of the taxes primarily takes the form of increases in the amount of the estate that is exempt from taxation and reductions in the estate and gift taxes' top marginal rates. EGTRRA set the amount of the exemption under the estate tax at $1 million for 2002, with scheduled increases to $1.5 million for 2004, $2 million for 2006, and $3.5 million for 2009. The law also reduced the top marginal rate paid under the tax in 2002 to 50 percent; it provides for additional declines of 1 percentage point annually through 2007. At that point, the maximum rate stabilizes at 45 percent from 2007 through 2009. In 2002, the amount of the gift tax exemption rose permanently to $1 million.

In 2010, the law repeals estate and generation-skipping transfer taxes, and the top rate on taxable gifts falls to equal the top rate in the individual income tax, currently legislated to be 35 percent. All of EGTRRA's provisions expire on December 31, 2010. As a result, the estate and gift tax returns to its unified pre-EGTRRA form, with a top marginal rate for 2011 of 55 percent. In addition, the amount of an estate and of taxable gifts that is exempt from taxation drops to $1 million.

EGTRRA also phases out (between 2002 and 2005) the credit for state death taxes that is allowable under current law. The credit is scheduled to be repealed in 2005; EGTRRA replaces it with a deduction for death taxes paid to any state or the District of Columbia.

EGTRRA has substantially reduced the number of estates subject to the estate tax relative to the number affected under earlier law. For example, before EGTRRA, about 30,400 estates would have been subject to the tax in 2005, compared with about 16,700 expected now. Similarly, under prior law, about 38,100 estates would have been subject to the tax in 2010, compared with zero under EGTRRA. EGTRRA has also made estate planning significantly more complicated: people now face not only the traditional uncertainty about when they will die and what the ultimate size of their estate will be but also the complexity of legislated phaseouts, repeal, and ultimate reinstatement of the estate and gift tax. The transfer of wealth to heirs during one's life through the strategic use of gifts (called inter vivos gifting), which is also a significant part of many taxpayers' estate plans, has also become more complicated under EGTRRA.

Several options could be designed to modify the scheduled phaseouts and eventual repeal of the estate tax (and generation-skipping transfer taxes). They range from freezing EGTRRA's provisions as they stand in particular years (Options 1 and 2) to accelerating the repeal of estate taxes (Options 3 and 4).

- Option 1 would retain the estate and gift taxes but permanently freeze the exemption and top rate at their levels in 2005—for an estate exemption level of $1.5 million, a taxable gift exemption of $1 million, and a top marginal rate of 47 percent. In 2005 as well, the state death tax credit would be fully phased out and treated as a deduction. This option would increase revenues by $10.6 billion over the 2004-2008 period. Under it, receipts would rise in 2007 and several subsequent years but would drop after 2011, when EGTRRA's provisions would have expired. Approximately 18,800 estates would be required to pay some federal estate tax in 2009 under this option, compared with approximately 12,300 under EGTRRA.

- Option 2 would retain the estate and gift taxes but permanently set the exemption at $3.5 million and the top tax rate at 50 percent, starting in 2004. The state death tax credit would be fully phased out in 2004, and state death tax payments would be treated as a deduction. Under this option, approximately 4,600 estates would be required to file federal estate and gift tax returns in 2005, compared with approximately 15,700 under EGTRRA. The option would decrease revenues by $22.7 billion over the 2004-2008 period.

- Option 3 would permanently repeal the estate tax in 2004. It would retain the gift tax, with an exemption of $1 million, and set the top gift tax rate to equal the top individual income tax rate. As is the case under EGTRRA, the option would allow each estate to increase, or "step up," the basis of the assets being transferred by as much as $1.3 million. That element of the option affects the calculation of capital gains (or losses)—and any applicable taxes—when the assets are eventually sold. A capital gain or loss on an asset is measured by the amount of the proceeds received from its sale minus the taxpayer's basis in the property. A taxpayer's basis generally represents his or her investment in an asset. "Carryover basis" on inherited property means that the basis of an asset in the hands of the heir is the same as it was in the hands of the decedent. "Stepped-up basis," for estate tax purposes, means that the basis of the property passing from a decedent's estate is generally the fair market value on the date of the decedent's death or on the alternate valuation date, as specified by law. This option would also increase by $3 million the basis of property that could be transferred to a surviving spouse. It would reduce revenues by $137.0 billion over the period from 2004 through 2008.

- Option 4 would make the repeal of EGTRRA's estate tax provisions permanent in 2010 and permanently freeze the gift tax provisions as EGTRRA specifies for 2010. This option would reduce revenues by $161.7 billion over the 2004-2013 period.

Advocates of these options might argue that they would simplify estate planning by providing more certainty about future estate and gift tax law. Another potential benefit would be the options' exemption of smaller estates from the filing of estate tax returns, which would reduce the filing burden of those taxpayers. Under the options, smaller estates would also be more likely to avoid incurring estate tax liability, which would reduce the potential for small businesses to have to liquidate to pay estate taxes.

Yet some observers criticize the first two options, which would retain the estate and gift taxes, as having the potential to hurt small businesses. They point out that under the options, federal estate tax returns would still have to be filed for some estates and some estates would still incur estate tax liability. Other critics of these options would oppose the permanent increase in the exemption, preferring that it return to $1 million in 2011.

Opponents of the options for repealing the estate tax support the progressivity of estate and gift taxes and believe that they reduce the concentration of wealth in the United States. Some critics might also contend that repealing the estate tax would reduce charitable giving because it would eliminate the tax deduction for charitable bequests and thus an incentive that encourages individuals to make bequests. They also point out that, first, the negative impact of the estate tax on small estates and closely held businesses (for example, family-owned firms) could be largely avoided by increasing the amount of the estate that was exempt from taxation; and second, even before EGTRRA, very few businesses were forced to liquidate to pay estate taxes. Critics note as well that the repeal options do not eliminate the filing burden because many estates will still need to file returns and pay estate tax under state law.

Both proponents and opponents of the estate and gift taxes make a variety of claims about the taxes' effect on savings, capital accumulation, and economic growth. However, research in those areas is inconclusive.